



# Leases

## Handbook

**US GAAP**

September 2024

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# Your guide to lease accounting

Almost all entities are lessees; therefore, Topic 842 affects almost all organizations, public and private, across all industries. The assets they lease encompass a wide range, including real estate, equipment, fleet and automobiles, among many others. They, along with lessors, must navigate new transaction types and economic events as they arise.

Successfully applying Topic 842 can present challenges and complexities. It frequently requires careful judgment and estimation. It also requires an understanding of how changes in business practices and contractual arrangements, as well as economic events, affect an entity's lease accounting. As a result of these changes, economic events and new transaction types, entities may need to apply aspects of the guidance they have not previously utilized or applied.

Organized in a Q&A format, this handbook is intended to help you focus effectively and efficiently on the accounting requirements of Topic 842 and answers those key questions that continue to arise in practice about their application. Our periodic updates address new questions as they arise, as well as standard setting and regulatory changes and developments. We give examples and observations to help explain key concepts.

Scott Muir and Amy Luchkovich  
**Department of Professional Practice, KPMG LLP**

# About this publication

The purpose of this Handbook is to assist you in understanding Topic 842, Leases.

## Accounting literature

Unless otherwise stated, references to the leases standard and/or Topic 842 comprise all of the following Accounting Standards Updates (ASUs):

- No. 2016-02, Leases (Topic 842)
- No. 2018-01, Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842
- No. 2018-10, Codification Improvements to Topic 842, Leases
- No. 2018-11, Leases (Topic 842): Targeted Improvements
- No. 2018-20, Leases (Topic 842): Narrow-Scope Improvements for Lessors
- 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
- No. 2020-02, Financial Instruments—Credit Losses (Topic 326) and Leases (Topic 842): Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 119 and Update to SEC Section on Effective Date Related to Accounting Standards Update No. 2016-02, Leases (Topic 842)
- No. 2020-05, Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities
- No. 2021-05, Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments
- No. 2021-09, Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities
- No. 2023-01, Leases (Topic 842): Common Control Arrangements

## Organization of the text

Each chapter of this Handbook includes excerpts from the FASB's Accounting Standards Codification® and overviews of the relevant requirements. Our in-depth guidance is explained through Q&As that reflect the questions we are encountering in practice. We include observations and examples to explain key concepts, and we explain the changes from legacy US GAAP (Topic 840).

Our commentary is referenced to the Codification and to other literature, where applicable. The following are examples:

- 842-10-25-1 is paragraph 25-1 of ASC Subtopic 842-10.
- ASU 2016-02.BC160 is paragraph 160 of the basis for conclusions to ASU 2016-02.

- TRG 11-16.56 is agenda paper no. 56 from the meeting of the Financial Accounting Standards Board's (FASB) and the International Accounting Standards Board's (IASB) Joint Transition Resource Group for Revenue Recognition (TRG) held in November 2016.
- SAB Topic 11.M is SEC Staff Accounting Bulletin Topic 11.M.

## Interaction with revenue recognition

As you use this Handbook, you may be surprised by the level of interaction between the requirements for lessors under Topic 842 and the requirements for suppliers under FASB ASC Topic 606, Revenue from Contracts with Customers. This link between the two Topics acknowledges the Board's view that leasing is, fundamentally, a revenue-generating activity for lessors.

For an in-depth understanding of the requirements of Topic 606, see KPMG Handbooks, [Revenue recognition](#) and [Revenue for software and SaaS](#), and the latest news on KPMG [Financial Reporting View](#).

## September 2024 edition

The September 2024 edition of our Handbook includes new and updated interpretations and examples. These come from our experiences with companies applying Topic 842; discussions with industry, preparer and peer groups; and discussions with the FASB and SEC staffs.

New Questions and Examples added in this edition are identified in the Handbook with \*\* and items that have been significantly updated or revised are identified with #. Questions and Examples included in previous editions (regardless of when added or updated), and those that have not been significantly updated in this edition, are no longer marked.

The [Index of changes](#) lists the additions and changes made in this edition to assist you in locating recently added or updated content.

## Future developments

Although all entities have now adopted Topic 842 and have issued financial statements thereunder, questions remain and interpretations of Topic 842 continue to evolve. This means that some positions may change over time, and positions on new issues will emerge.

For the Questions in this Handbook where we are aware of ongoing discussions and the potential for a position to change, we have indicated that in our interpretive response.

## Abbreviations

We use the following abbreviations in this Handbook:

CPI	Consumer Price Index
ROU	Right-of-use (asset)
TRG	The IASB and the FASB's Joint Transition Resource Group for Revenue Recognition

We use the following additional abbreviations in the charts and diagrams in this Handbook:

FV	Fair value
IDC	Initial direct cost
IBR	Incremental borrowing rate
PP&E	Property, plant and equipment
PV	Present value
RVG	Residual value guaranteee

# 1. Executive summary

## Transparency and comparability

Topic 842 was developed to provide financial statement users with more information about an entity's leasing activities.

- Lessees recognize all leases, including operating leases, with a term greater than 12 months on-balance sheet.
- Lessees and lessors disclose key information about their leasing transactions.

## Effective date

Public business entities apply Topic 842 for interim and annual periods in fiscal years beginning after December 15, 2018.

Not-for-profit entities that have issued or are conduit bond obligors for securities that are traded, listed or quoted on an exchange or an over-the-counter market, that had not yet issued GAAP-compliant financial statements reflecting the adoption of Topic 842 before June 3, 2020 apply Topic 842 for interim and annual periods in fiscal years beginning after December 15, 2019.

All other entities apply Topic 842 for annual periods in fiscal years beginning after December 15, 2021, and interim periods in fiscal years beginning one year later.

Certain public business entities, those who would not meet the definition of a public business entity other than because their financial statements or summarized financial information are included in another entity's SEC filing, are permitted to use the adoption dates for 'other entities'.

Early adoption is permitted for all entities.

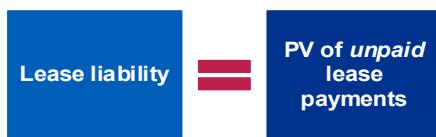
## A lessee's perspective – leases on balance sheet

### The debits and credits

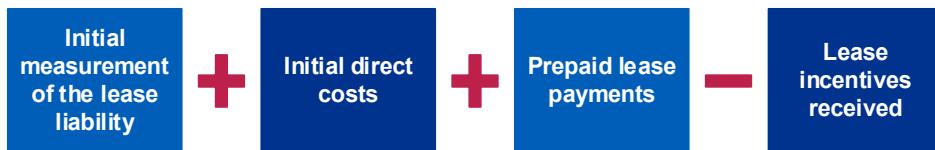
A lessee recognizes a lease liability and an ROU asset for all leases, including operating leases, with a term greater than 12 months, which will significantly increase reported assets and liabilities for some lessees.

The critical accounting determination is whether a contract is or contains a lease, the new on-/off-balance sheet test. Lease classification criteria affect how lessees measure and present lease expense and cash flows – not whether the lease is on- or off-balance sheet as they did under legacy US GAAP (Topic 840).

For all leases, the lease liability is measured as shown below, both initially and subsequently. Lease payments exclude contingent payments other than those that are in-substance fixed. The discount rate for the lease is generally the lessee's incremental borrowing rate unless the lessor's rate implicit in the lease is readily determinable, in which case it is used. Private entities can elect, by class of underlying leased asset, to use a risk-free discount rate.

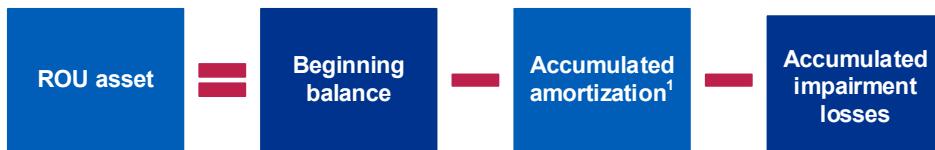


For all leases, on initial recognition the ROU asset is derived from the calculation of the lease liability. Topic 842 has a narrow definition of initial direct costs, and some costs incurred in negotiating and arranging a lease that were capitalized under Topic 840 are now expensed as incurred.



The measurement of the ROU asset subsequent to initial recognition depends on whether the lease is a finance lease or an operating lease.

#### For finance leases:



Note:

1. The ROU asset in a finance lease is generally amortized on a straight-line basis.

**For operating leases**, there are two approaches to subsequent measurement, which yield the same result.

**Method 1** derives the carrying amount of the ROU asset from the measurement of the lease liability at each reporting date.



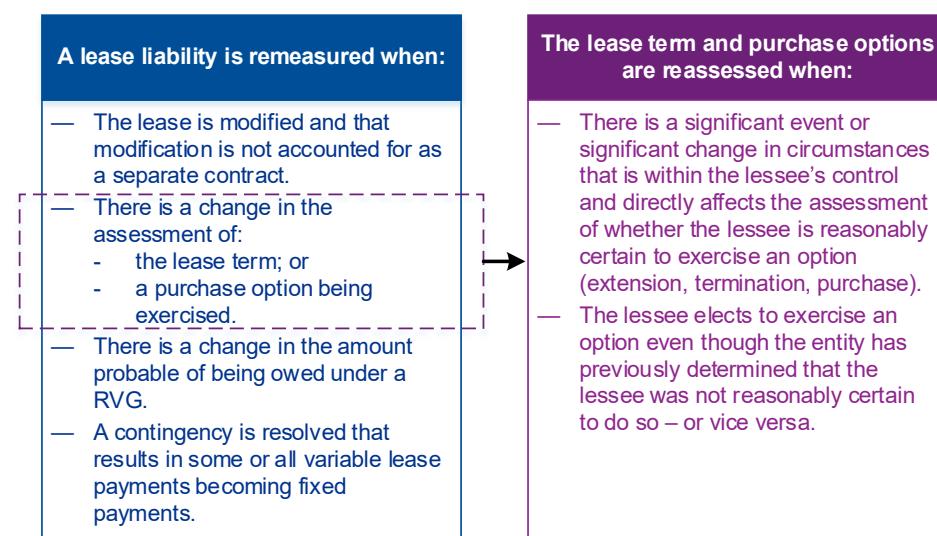
**Method 2** amortizes the ROU asset, and the periodic amortization is the difference between the straight-line total lease cost for the period (including amortization of initial direct costs) and the periodic accretion of the lease liability using the effective interest method.



The ROU asset (for finance and operating leases) is subject to impairment testing under Topic 360 (property, plant and equipment).

Once an operating lease ROU asset is impaired, the two methods above no longer apply. Instead, subsequent amortization of the ROU asset is calculated in the same way as for finance lease ROU assets – generally on a straight-line basis over the remaining lease term. However, the ROU asset amortization and lease liability accretion continue to be accounted for as a single, operating lease cost.

## More frequent revisions to lease accounting require processes and controls



## Build-to-suit guidance substantially revised

Topic 842 eliminates the legacy build-to-suit lease accounting guidance, and instead stipulates that a lessee is the accounting owner of an asset under construction when it controls that asset before the lease commencement date. Topic 842 does not consider exposure to construction period risks, nor does it explicitly prohibit certain activities. Because Topic 842 changes the underlying principle to determine when a lessee is the accounting owner of an asset under construction, some different accounting outcomes result as compared with Topic 840.

When a lessee is deemed to be the accounting owner of an asset under construction, the changes to the sale-leaseback guidance generally make it easier for lessees to remove real estate assets recognized during the construction period from their balance sheets.

The transition provisions of Topic 842 resulted in many entities derecognizing build-to-suit assets and liabilities that were on the balance sheet after the end of the construction period under Topic 840.

## A lessor's perspective – the devil is in the details

### Overall model substantially unchanged

A lessor classifies leases using criteria similar to those under Topic 840, as (1) sales-type, (2) direct financing, or (3) operating leases. However, the elimination of lessor-specific classification criteria related to collectibility and unreimbursable costs will result in a different classification for some leases classified as operating leases under Topic 840. Leveraged lease classification is eliminated prospectively.

Once classified, the accounting model applied to each type of lease is substantially similar to the lessor accounting model under Topic 840.

	Balance sheet	Income statement	Cash flow statement
Sales-type and direct financing leases	<ul style="list-style-type: none"> <li>— Recognize net investment in the lease</li> <li>— Derecognize the underlying asset</li> </ul>	<ul style="list-style-type: none"> <li>— Selling profit (loss)<sup>1</sup></li> <li>— Interest income over the lease term</li> </ul>	Cash received from leases classified as operating cash flows <sup>2</sup>
Operating leases	Continue to recognize the underlying asset	Lease income generally on a straight-line basis over the lease term	Cash received from leases classified as operating cash flows

Notes:

1. Selling profit is recognized at lease commencement for sales-type leases and over the lease term for direct financing leases. Selling losses are recognized at lease commencement for both sales-type and direct financing leases.
2. Lessors that are depository or lending institutions in the scope of Topic 942 (depository and lending institutions) classify the principal portion of cash payments received from leases as investing cash flows; the interest portion is classified as operating cash flows.

### Key concepts and definitions mostly consistent with legacy US GAAP

Along with the basic lessor accounting model remaining substantially unchanged from Topic 840, most of the key definitions and concepts relevant to lessor accounting are also consistent with legacy US GAAP. The following are examples.

Term	Equals
<b>Net investment in the lease:</b>	Lease receivable + unguaranteed residual asset
<b>Lease receivable:</b>	PV of the lease payments + PV of guaranteed portion of estimated residual value

Term	Equals
<b>Unguaranteed residual asset:</b>	PV of unguaranteed portion of estimated residual value
<b>Lease payments:</b>	Undiscounted fixed (including in-substance fixed) payments + optional payments that are reasonably certain to be paid
<b>Discount rate for the lease:</b>	Rate implicit in the lease, which is ... The rate that causes the PV of lease payments + PV of estimated residual value = FV of the underlying asset (net of related investment tax credits) + capitalizable initial direct costs

## But a change in the treatment of collectibility uncertainties

Unlike under Topic 840, a lease with collectibility uncertainties can be classified as a sales-type lease. If collectibility of the lease payments, plus any amount necessary to satisfy a lessee residual value guarantee, is not probable for a sales-type lease, lease payments received (including variable lease payments) are recognized as a deposit liability (i.e. not recognized as lease income) and the underlying asset generally is not derecognized until collectibility of the remaining amounts becomes probable.

When collectibility is not probable for a lease that otherwise would be a direct financing lease, it is classified as an operating lease. Lease income recognized for operating leases when collectibility is not probable is limited to cash received from the lessee until collectibility of substantially all the remaining lease payments becomes probable.

## Issues arising from significant variable lease payments

Leases with variable lease payments for which a Day 1 loss would result if classified as sales-type or direct financing are required to be classified as operating leases. This is generally consistent with how such leases were classified under Topic 840.

## And a narrower definition of initial direct costs

The new definition of initial direct costs includes only those incremental costs of a lease that would not have been incurred if the lease had not been obtained, which is narrower than legacy US GAAP. Some costs, like legal fees and allocated internal costs, that an entity was permitted to capitalize as initial direct costs under Topic 840 are expensed as incurred under Topic 842. For some lessors, this may result in recognizing more expenses before the start of a lease and higher margins on lease income earned over the lease term.

Typical initial direct costs	
Include	Exclude
<ul style="list-style-type: none"> <li>— Commissions</li> <li>— Payments made to an existing tenant to incentivize that tenant to terminate the lease</li> </ul>	<ul style="list-style-type: none"> <li>— Legal fees</li> <li>— Costs of evaluating the prospective lessee's financial condition</li> <li>— Costs of negotiating lease terms and conditions</li> <li>— General overheads</li> </ul>

Applicable to both lessees and lessors

## Allocating consideration to lease and non-lease components

Topic 842 only governs the accounting for leases. If there are both lease and non-lease components (e.g. services), an entity applies Topic 842 to the lease component(s) and other US GAAP to the non-lease component(s).



The consideration in the contract is allocated in a way that maximizes the use of observable information. The lessee performs the allocation on a relative stand-alone price basis. The lessor follows the transaction price allocation guidance in Topic 606 (revenue from contracts with customers).

As the diagram shows, lessee payments of lessor executory costs do not represent payments for a good or service, and therefore are not non-lease components. Examples include payments to cover the lessor's costs of ownership, such as property taxes or insurance. Lessee payments of those costs are allocated to the lease and non-lease components in the same manner as all other payments in the contract.

Consequently, those payments are not excluded from lease accounting as they were under Topic 840. However, an exception arises for lessors if the lessee's payments of those costs are made directly to a third party (e.g. a taxing authority or insurer). In those cases, the costs and the lessee's payments thereof are excluded from the lessor's accounting for the lease.

## Lessor practical expedient for sales and other similar taxes

Lessors may elect to present all funds collected from lessees for sales and other similar taxes net of the related sales tax expense. This is an entity-wide accounting policy election made for all of the lessor's leases.

## Practical expedients not to separate lease and non-lease components

Lessees may elect to account for non-lease components as part of the lease component to which they relate. This election is made by class of underlying asset, and the combined component is accounted for a single *lease* component.

Lessors have a similar option with two main differences:

- the lease and non-lease components must meet specified criteria to qualify to be combined; and
- the combined component is accounted for under Topic 606 (i.e. as a single performance obligation), rather than under Topic 842 if the non-lease element(s) of the combined component is (are) 'predominant'; otherwise, the combined component is accounted for as an operating lease.

## Sale-leaseback accounting substantially changed

Topic 842 eliminates sale-leaseback transactions as an off-balance sheet financing proposition for lessees. This is because seller-lessees recognize an ROU asset and a lease liability in place of the underlying asset (and any asset financing repaid with the sale proceeds). Unlike Topic 840, the sale-leaseback guidance is the same for real estate assets as it is for all other assets (e.g. equipment).

Topic 606 is used by both the seller-lessee and the buyer-lessor to assess whether a sale of the asset from the seller-lessee to the buyer-lessor has occurred. Purchase options generally preclude sale accounting, unless (1) the strike price of the repurchase option is the fair value of the asset at the option exercise date, and (2) assets that are substantially the same as the underlying asset are readily available in the marketplace. This second requirement precludes real estate sale-leaseback transactions with repurchase options from qualifying for sale accounting.

In addition, sale and finance (previously, capital) leasebacks no longer exist; a conclusion that a leaseback would be a finance (sales-type) lease results in a conclusion that the sale-leaseback transaction does not qualify as a sale (seller-lessee)/purchase (buyer-lessor).



If the sale-leaseback transaction does not qualify as a sale/purchase, both the seller-lessee and the buyer-lessor account for the transaction as a financing arrangement. The seller-lessee recognizes a financial liability and continues to recognize and depreciate the asset, while the buyer-lessor recognizes a financial asset (i.e. a receivable).

If the sale-leaseback transaction does qualify as a sale/purchase of the underlying asset, the seller-lessee recognizes the entire gain from the sale, subject to adjustment for off-market terms, at the time of sale rather than over the leaseback term; this was typically the result under legacy US GAAP. The buyer-lessor accounts for the purchase of the underlying asset in the same manner as any other purchase of a nonfinancial asset, subject to a requirement to adjust the purchase price of the underlying asset for off-market terms.

## Expanded qualitative and quantitative disclosures

Topic 842 requires lessees and lessors to disclose significant qualitative and quantitative information about their leases. Entities need to maintain appropriate systems, processes and internal controls to completely and accurately capture the lease data necessary to provide these disclosures.

The following are examples.

Qualitative disclosures	
Lessees	Lessors
<ul style="list-style-type: none"> <li>— Significant judgments and assumptions, such as whether a contract contains a lease, stand-alone prices for lease and non-lease components, and the discount rate for the entity's leases</li> <li>— Information about the nature of leases, such as the terms and conditions of variable lease payments, extension and termination options, purchase options, and residual value guarantees</li> </ul>	<ul style="list-style-type: none"> <li>— Significant accounting judgments and estimates</li> <li>— Information about the nature of leases, such as the nature of variable payment arrangements, and termination, renewal, and purchase options</li> <li>— Information about how the lessor manages residual asset risk, including information about residual value guarantees and other means of limiting that risk.</li> </ul>

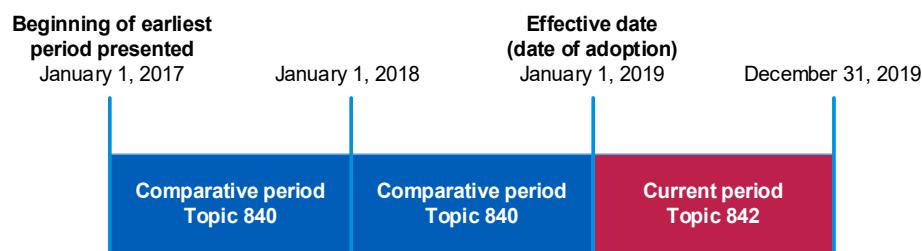
Quantitative disclosures	
Lessees	Lessors
<ul style="list-style-type: none"> <li>— Operating lease cost</li> <li>— Amortization of finance lease right-of-use assets and interest on finance lease liabilities</li> <li>— Variable lease cost</li> <li>— Weighted-average remaining lease term, and weighted-average discount rate</li> <li>— Maturity analysis of lease liabilities</li> </ul>	<ul style="list-style-type: none"> <li>— Maturity analysis of lease receivables for sales-type and direct financing leases and of lease payments for operating leases</li> <li>— Selling profit (or loss) recognized at lease commencement and interest income for sales-type and direct financing leases</li> <li>— Operating lease income</li> <li>— Variable lease income</li> </ul>

## Modified retrospective transition, with two options for date of initial application

Topic 842 requires a modified retrospective transition, with the cumulative effect of transition, including initial recognition by lessees of lease (right-of-use) assets and lease liabilities for existing operating leases, as of either:

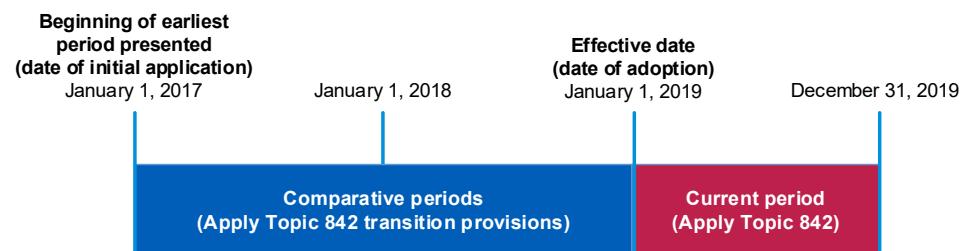
- the effective date (the 'effective date method'); or
- the beginning of the earliest comparative period presented (the 'comparative method').

Under the effective date method, the entity's comparative period reporting is unchanged. Comparative reporting periods are presented in accordance with Topic 840, while periods subsequent to the effective date are presented in accordance with Topic 842. The following timeline illustrates this.



In contrast, under the comparative method, the entity's date of initial application is the beginning of the earliest comparative period presented. The Topic 842 transition guidance is then applied to all comparative periods presented.

If a calendar year-end public business entity adopts Topic 842 using the comparative method, then the following are the relevant dates.



Under either transition method, Topic 842 includes practical expedients intended to ease the burden of adoption on preparers.

Package of practical expedients (all or nothing) <sup>1</sup>	Use of hindsight <sup>2</sup>	Land easements
An entity may elect not to reassess: <ul style="list-style-type: none"> <li>— whether expired or existing contracts contain leases under</li> </ul>	An entity may use hindsight in determining the lease term, and in assessing the likelihood that a lessee purchase option will be exercised.	An entity may elect not to reassess whether land easements meet the definition of a lease if they were not accounted for as leases under Topic 840.

Package of practical expedients (all or nothing) <sup>1</sup>	Use of hindsight <sup>2</sup>	Land easements
<ul style="list-style-type: none"> <li>the new definition of a lease;</li> <li>— lease classification for expired or existing leases; and</li> <li>— whether previously capitalized initial direct costs would qualify for capitalization under Topic 842.</li> </ul>		
Each of the three practical expedients may be elected separately from the other two practical expedients.		
Practical expedients are applied consistently to all leases – i.e. all leases for which the entity is a lessee or a lessor – for leases that commence before the effective date.		

## Notes:

1. The practical expedients do not grandfather previous errors in the application of Topic 840 – e.g. in identifying leases or in lease classification.
2. Applies to estimates and judgments in applying lease accounting, but does not apply to changes in facts such as those resulting from changes to the terms and conditions of a lease, or changes to indices or rates.

# 2. Scope

## Detailed contents

### How the standard works

#### 2.1 Explicit scope exclusions

##### Observation

Assets under construction are outside the scope of Topic 842

##### Questions

- 2.1.10 Natural resources scope exclusion – production and development activities
- 2.1.15 Natural resources scope exclusion – rights of use in addition to the natural resources rights
- 2.1.20 Natural resources scope exclusion – different parties own the mineral rights and the land
- 2.1.30 Natural resources scope exclusion – adjacent land rights
- 2.1.40 Applicability of Topic 842 to 'bearer plants'

##### Example

- 2.1.10 Natural resources scope exclusion – various scenarios

#### 2.2 Interaction with other standards

- 2.2.1 Derivative instruments
- 2.2.2 Service concession arrangements

##### Question

- 2.2.10 Accounting for a foreign exchange component in an operating lease contract

#### 2.3 In the scope of Topic 842

- 2.3.1 Non-core assets
- 2.3.2 Long-term leases of land
- 2.3.3 Certain sales with repurchase rights – supplier's perspective

##### Observation

Leases of non-core assets are in scope

##### Questions

- 2.3.10 Land easements
- 2.3.20 Sales of out-of-scope nonfinancial assets with a seller repurchase right or obligation
- 2.3.30 Accounting for sales with repurchase rights by suppliers and customers
- 2.3.40 Heat supply contracts for nuclear fuel

**2.4 Differences/changes in scope**  
**Comparison to legacy US GAAP**

## How the standard works

Topic 842 applies to arrangements that meet the definition of a lease except as otherwise indicated in section 2.1. Leases of the following are in the scope of Topic 842:

- non-core assets;
- long-term leases of land; and
- certain sales with repurchase rights (from the supplier's perspective).

An operating entity's involvement with a grantor's infrastructure in a service concession arrangement in the scope of Topic 853 (service concession arrangements) is not a lease in the scope of Topic 842.

We believe the scope of Topic 842 was intended to be consistent with that of Topic 840. [\[ASU 2016-02.BC110\]](#)

## 2.1 Explicit scope exclusions

 **Excerpt from ASC 842-10**

**15 Scope and Scope Exceptions**

**General**

**15-1** An entity shall apply this Topic to all **leases**, including **subleases**. Because a lease is defined as a **contract**, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration, this Topic does not apply to any of the following:

- a. Leases of intangible assets (see Topic 350, Intangibles—Goodwill and Other).
- b. Leases to explore for or use minerals, oil, natural gas, and similar nonregenerative resources (see Topics 930, Extractive Activities—Mining, and 932, Extractive Activities—Oil and Gas). This includes the intangible right to explore for those natural resources and rights to use the land in which those natural resources are contained (that is, unless those rights of use include more than the right to explore for natural resources), but not equipment used to explore for the natural resources.
- c. Leases of biological assets, including timber (see Topic 905, Agriculture).
- d. Leases of **inventory** (see Topic 330, Inventory).
- e. Leases of assets under construction (see Topic 360, Property, Plant, and Equipment).

2.1.10 Topic 842 is an inclusive standard, and applies to all leases (including subleases) unless it is specifically excluded from its scope. The following are the specific scope exclusions from Topic 842. [842-10-15-1]

Excludes leases of/to ...	Commentary
<b>Intangible assets</b>	Intangible assets and rights to use intangible assets continue to be accounted for under Topic 350 (goodwill and other intangibles).
<b>Explore for or use non-regenerative resources (e.g. minerals, oil or natural gas)</b>	<ul style="list-style-type: none"> <li>— The scope exclusion includes the intangible right to explore for those natural resources, and rights to use the land in which those natural resources are contained, unless those rights of use include more than the right to explore for natural resources (e.g. the right to explore and/or develop land).</li> <li>— Rights to use equipment used to explore for natural resources are in the scope of Topic 842.</li> </ul>
<b>Biological assets (e.g. crops)</b>	The scope exclusion includes leases of timber, to be consistent with Topic 840.

Excludes leases of/to ...	Commentary
<b>Inventory</b>	<p>Inventory is a defined term in US GAAP; only leases of assets that meet that definition are excluded from the scope of Topic 842. However, consider the following:</p> <ul style="list-style-type: none"> <li>— A determination of whether the asset is 'inventory' should be from the perspective of the customer (lessee) – i.e. whether the asset would be inventory or instead an item of property, plant or equipment for the customer (lessee). The arrangement should not be scoped out of Topic 842 solely because the asset was classified as inventory by the supplier (lessor). Manufacturers and dealers frequently lease assets, such as vehicles or machinery, that they classify as 'inventory' because they both sell and lease it to customers.</li> <li>— The description of an asset as 'inventory' does not in itself mean that a lease of that asset is outside the scope of Topic 842. For example, sometimes entities refer to a collection of assets, such as spare parts, as inventory. If those spare parts are depreciable assets under other accounting guidance, a right to use those assets is in the scope of Topic 842.</li> </ul>
<b>Assets under construction</b>	<ul style="list-style-type: none"> <li>— If a lessee controls the asset under construction before the commencement date of the lease, the transaction is in the scope of the sale-leaseback guidance.</li> <li>— Topic 842 includes guidance (and examples) about when a lessee controls an asset that is under construction before lease commencement, and guidance on accounting for costs associated with the construction or design of the underlying asset in a lease.</li> </ul> <p>Section 9.4 discusses determining when a lessee controls an asset that is under construction and the resulting accounting.</p>



## Observation

### Assets under construction are outside the scope of Topic 842

2.1.20 The Board observed that there was no clear conceptual basis for stipulating that an entity cannot lease an asset that is under construction. However, the Board concluded that the additional complexity that this concept would introduce into lease accounting was not justified by the relatively few situations (in relation to the overall volume of leases in the scope of Topic 842) in which those leases would exist. In reaching its conclusion, the Board further noted that in many cases it might be difficult to distinguish when a lessee controls the asset that is under construction itself, or controls the right to use that asset before construction is complete. [\[ASU 2016-02.BC110\(e\)\]](#)

 Question 2.1.10**Natural resources scope exclusion – production and development activities**

**Is a right granted to use land for production and development activities of natural resources outside the scope of Topic 842?**

**Background:** The natural resources scope exclusion in Topic 842 refers only to “leases to *explore for or use* minerals, oil...” [emphasis added]. Therefore, the question has arisen about whether the right to use an entity’s land for purposes that include production and development of natural resources is outside the scope of Topic 842. [\[842-10-15-1\(b\)\]](#)

**Interpretive response:** Yes, provided the contract does not also give the grantee rights to use the land that are unrelated to exploring for, producing, developing, or using the natural resources contained in the land. We believe the natural resources scope exclusion applies to land use rights that permit the grantee to undertake production and development activities related to minerals, oil, natural gas and similar non-generative resources. The basis for conclusions to ASU 2016-02 suggests that the natural resources scope exclusion is intended to be consistent with that in Topic 840, which historically considered land use arrangements such as these to be outside its scope. [\[ASU 2016-02-BC110\(b\)\]](#)

 Question 2.1.15**Natural resources scope exclusion – rights of use in addition to the natural resources rights**

**If natural resources rights are bundled with additional land-use rights, are the natural resource rights still excluded from the scope of Topic 842?**

**Background:** The natural resources scope exclusion in Topic 842 states that intangible rights to explore for natural resources and the right to use the land in which those natural resources are contained are excluded from the scope of Topic 842 “unless those rights of use include more than the right to explore for natural resources.” [\[842-10-15-1\(b\)\]](#)

Therefore, the question has arisen about whether this means that a grantee’s right to explore for, produce, develop or use natural resources is outside the scope of Topic 842 when the contract also includes additional land-use rights.

**Interpretive response:** Yes. If an entity’s land-use rights include natural resource rights and other land-use rights, the natural resource rights remain outside the scope of Topic 842. Some have questioned whether the quotation in the background means that land-use rights that include natural resource rights and other land-use rights are in the scope of Topic 842 in their entirety. However, we believe that language was intended to ensure that only natural resource rights were excluded from the scope of Topic 842, and that the natural

resources scope exclusion could not be misused to avoid lease accounting for other land-use rights with which natural resource rights could be bundled.

This conclusion means that natural resource rights bundled with other land-use rights (assuming those other land-use rights meet the definition of a lease) should be accounted for as a non-lease component.

- If the non-separation practical expedient is not elected, the natural resources non-lease component will be separated from the other land-use rights granted.
- If the non-separation practical expedient *is* elected (see section 4.4.1):
  - lessees will combine the natural resource non-lease component with the other land-use rights and account for the combined component as a single *lease* component; and
  - lessors will assess whether the natural resource non-lease component qualifies for combination with the other land-use rights (see paragraph 4.4.51) and if so, account for the combined component under Topic 842 or Topic 606, as appropriate (see paragraphs 4.4.53 – 4.4.55).

### Question 2.1.20

#### Natural resources scope exclusion – different parties own the mineral rights and the land

**Is a right to use land that contains natural resources to which the entity has mineral rights outside the scope of Topic 842 if the landowner is a different party from the owner of the mineral rights?**

**Background:** The owner of the land that contains the natural resources (e.g. oil or natural gas) may not be the holder of the rights to those natural resources. An entity may enter into separate contracts with (1) a holder of rights to explore for, develop and produce those natural resources and (2) the landowner for rights to use the land that contains the natural resources.

In this scenario, the question has arisen about whether the contract with the owner of the land that contains the natural resources is in the scope of Topic 842.

**Interpretive response:** Yes. Topic 842 states that the natural resources scope exclusion “includes the intangible right to explore for those natural resources and rights to use the land in which those natural resources are contained.” There is nothing in Topic 842 (or the basis for conclusions to ASU 2016-02) that suggests this scope exclusion is affected either by (1) who the landowner is (e.g. a party different from the mineral rights owner) or (2) the fact that the party granting the right to use the land that contains the minerals is different from the party granting the intangible right to explore for or use the natural resources.

[842-10-15-1(b)]



### Question 2.1.30

#### Natural resources scope exclusion – adjacent land rights

##### Is a right to use land to access a property that contains natural resources outside the scope of Topic 842?

**Background:** An entity may have rights to explore for or use natural resources on a given property. To access that property, the entity may enter into a contract with an adjacent landowner for rights to cross or otherwise use that landowner's property to access the property that contains the natural resources to which the entity has rights.

In this scenario, the question has arisen about whether the contract to use the adjacent property is outside the scope of Topic 842 because of the natural resources scope exclusion.

**Interpretive response:** No. The natural resources scope exclusion applies only to rights to use the land that contains the natural resources to which the entity has exploration or usage rights. A right to use land that does *not* contain natural resources to which the grantee has exploration or usage rights, such as the adjacent property described in the background, is not subject to the natural resources scope exclusion. Therefore, that right of use must be assessed to determine whether it is a lease (see chapter 3).

A right to cross or otherwise use a third party's land to access a property that contains natural resources to which the entity has rights may be a land easement (see Question 2.3.10).



### Example 2.1.10

#### Natural resources scope exclusion – various scenarios

##### Scenario 1: Natural resources depleted unexpectedly before end of contract

ABC Corp. is a mining company that mines numerous properties throughout the United States for various minerals (e.g. gold, silver and aggregate rock). ABC has long-term rights (40 years) to explore for, develop and produce minerals from a property.

At inception, ABC reasonably expected to explore for, develop and produce minerals for most or all of the 40-year term. However, 25 years after inception of those rights, ABC believes all of the minerals that existed on the property, or that can be mined cost effectively, have been extracted. Therefore, ABC is no longer mining the land – i.e. no longer exploring for, developing or producing minerals from the property. ABC continues to pay land use rights to the property owner under the non-cancellable agreement, but is now using the land solely for storing stockpiles of the extracted minerals.

The natural resources scope exclusion applies to the arrangement initially. It continues to apply at the end of Year 25 because the terms and the conditions of the contract have not been changed, and an entity would reassess whether a contract is or contains a lease only when the terms and conditions of the contract are changed.

### **Scenario 2: No intention to mine the natural resources (1)**

Assume the same facts as Scenario 1 except that, similar to other arrangements ABC has entered into, at inception of the contract, ABC has no intention to mine the land. ABC has entered into this agreement for 'protective' purposes – i.e. so competitors cannot mine the land. There is nothing in the agreement that either requires ABC to mine the land or precludes it from doing so.

The natural resources scope exclusion applies. This is because the lease identification guidance in Topic 842 does not differentiate between economic benefits derived from using the identified asset (e.g. using the land to mine) and economic benefits derived from holding the asset (e.g. for protective reasons). Applicability of the scope exclusion is not based on how the grantee chooses to derive economic benefit from its rights.

### **Scenario 3: No intention to mine the natural resources (2)**

DEF Corp. enters into a 40-year contract with Landowner that grants DEF the right to construct a shopping mall. DEF does not have mining operations and historically has not entered into mineral rights arrangements for the purpose of subleasing those rights. Additionally, there is no evidence that the property or surrounding areas contain meaningful mineral deposits. However, DEF and Landowner include in the contract a provision granting DEF the right to explore for, develop and produce whatever minerals exist in the land for the duration of the contract.

The natural resources scope exclusion does *not* apply. In this scenario, the contract between DEF and Landowner is not 'to explore for or use minerals, oil, natural gas, and similar nonregenerative resources', and DEF's rights of use clearly include more than the right to explore for, produce or develop natural resources. Instead, the contract is principally to permit DEF to construct a shopping mall on the property. To the extent there are substantive mineral exploration and use rights in the arrangement, DEF should account for those rights as a non-lease component of the contract.

### **Scenario 4: Some of the land restricted as to grantee's use**

GHI Corp. enters into a contract that grants it rights to explore for, develop and produce minerals from a property. The contract stipulates that a specified section of the property may not be mined because of its close proximity to the grantor's farm – mining there could affect the grantor's crops.

Because of the restriction, there are two units of account.

- The natural resources scope exclusion applies to the non-restricted section of the property because GHI has the right to explore for, develop and produce minerals from that section.
- The accounting for the restricted section of the property depends on GHI's rights over it.

**GHI has no rights to use the restricted section of the property.** In that case, there is no accounting by GHI related to the restricted section of the property.

**GHI has rights to use the restricted section of the land.** The rights to use the restricted land do not qualify for the natural resources scope exclusion. Even though there is a single contract and a single landowner/grantor, this situation is not substantively different from that in Question 2.1.30. The fact that the land may contain natural resources (unlike the fact pattern in Question 2.1.30) is not relevant because GHI is not permitted to explore for, develop or produce those resources. GHI would assess whether its rights to use the restricted section of the land meet the definition of a lease (see chapter 3)



#### Question 2.1.40

#### Applicability of Topic 842 to 'bearer plants'

### Are leases of 'bearer plants' outside the scope of Topic 842?

**Background:** Topic 842 and IFRS 16 both exclude leases of biological assets from their scope. However, IFRS 16 refers to biological assets that are in the scope of the relevant standard on agriculture (IAS 41). [I842-10-15-1(c), IFRS 16.3(b)]

Bearer plants are excluded from the scope of IAS 41, and therefore are not subject to the biological assets scope exception in IFRS 16. IFRS® Accounting Standards define a 'bearer plant' as a living plant that: [IAS 41.5]

- is used in the production or supply of agricultural produce;
- is expected to bear produce for more than one period; and
- has a remote likelihood of being sold as agricultural produce, except for incidental scrap sales.

US GAAP does not define 'biological asset' or 'bearer plant'. However, because Topic 842 includes the biological assets scope exception in Topic 842 principally for reasons of convergence with IFRS 16, questions have arisen about whether bearer plants qualify for this scope exception.

**Interpretive response:** Yes, leases of plants that would meet the definition of a bearer plant under IFRS Accounting Standards are outside the scope of Topic 842. The following considerations support this conclusion.

- While US GAAP does not define a biological asset, the basis for conclusions to ASU 2016-02 refers to 'plants and living animals' as biological assets, without distinguishing between types of plants. [ASU 2016-02.BC110(c)]
- The basis for conclusions to ASU 2016-02 also discusses that the Board wanted the accounting requirements for biological assets to be contained in a single Topic – i.e. Topic 905 (agriculture). Topic 905 applies to the activities of growing fruits including citrus, grapes, berries, other fruits, and nuts, which frequently involve the use of plants that meet the definition of bearer plants under IFRS Accounting Standards. [ASU 2016-02.BC110(c)]
- When the Board first decided that it would exclude biological assets from the scope of Topic 842 (i.e. before issuance of the FASB's 2009 Discussion Paper on leases), bearer plants were not yet scoped out of IAS 41; and

when IAS 41 was amended subsequently, the Board did not consider similar amendments to US GAAP.

## 2.2 Interaction with other standards



### Excerpt from ASC 842-10

> Other Considerations

**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.



### Excerpt from ASC 815-10

• • > Leases

**15-79** Leases that are within the scope of Topic 842 are not derivative instruments subject to this Subtopic, although a derivative instrument embedded in a lease may be subject to the requirements of paragraph 815-15-25-1.

• • > Residual Value Guarantees

**15-80** Residual value guarantees that are subject to the requirements of Topic 842 on leases are not subject to the requirements of this Subtopic.

**15-81** A third-party residual value guarantor shall consider the guidance in this Subtopic for all residual value guarantees that it provides to determine whether they are derivative instruments and whether they qualify for any of the scope exceptions in this Subtopic. The guarantees described in paragraph 842-10-15-43 for which the exceptions of paragraphs 460-10-15-7(b) and 460-10-25-1(a) do not apply are subject to the initial recognition, initial measurement, and disclosure requirements of Topic 460.

### 2.2.1 Derivative instruments

2.2.10 Leases that are within the scope of Topic 842 are not derivative instruments. Residual value guarantees that are subject to the guidance in

Topic 842 are not subject to the guidance in Topic 815 (derivatives and hedging); residual value guarantees are discussed in section 5.4.6. [842-10-15-43]

2.2.20 However, a derivative instrument embedded in a lease may be subject to the requirements of Topic 815. For example, a third-party residual value guarantor is required to consider the guidance in Subtopic 815-10 for all residual value guarantees that it provides to determine whether they (1) are derivative instruments, and (2) qualify for any of the scope exceptions under Subtopic 815-10. [815-10-15-80 – 15-81]



### Question 2.2.10

#### **Accounting for a foreign exchange component in an operating lease contract**

#### **Is an embedded foreign exchange component separated from an operating lease as an embedded derivative?**

**Background:** Consider a scenario in which Lessee LE, a US company whose functional currency is the US dollar, enters into a lease for a building from Lessor LR, a foreign-owned company whose functional currency is the Japanese yen. The lease payments due to LR are payable in euros, which is not the currency in which the price of an aircraft lease is routinely denominated in international commerce. The lease is classified as an operating lease.

**Interpretive response:** It depends. There are differing views about this question. In the absence of further or changed guidance from the FASB or SEC staff, we believe either of the following views is reasonable.

#### **View A: No – Topic 815 scope exception applies by analogy**

Under Subtopic 815-15, foreign currency transactions are not considered to contain embedded foreign currency derivatives if the transactions are: [815-15-15-5]

- a. monetary items;
- b. have principal payments, interest payments or both denominated in a foreign currency; and
- c. are subject to the requirement in Subtopic 830-20 to recognize any foreign currency transaction gain or loss in earnings.

Based on discussions with the FASB staff, we believe that when criteria (a) and (c) are met, it is reasonable for a lessee to conclude that criterion (b) is also met by analogy when the operating lease payments are denominated in a foreign currency, despite that those payments do not include explicit principal or interest elements.

#### **(a) Monetary item**

The lease liability is a monetary liability (see paragraph 6.4.240). Therefore, an operating lease transaction gives rise to a monetary item and meets criterion (a).

**(c) Foreign currency transaction gains or losses in earnings**

Foreign currency transaction gains or losses resulting from remeasuring the lease liability and ROU asset into the lessee's functional currency (see paragraph 6.4.240) each period are recognized in current period earnings. Therefore, criterion (c) is met.

**View B: It depends – Topic 815 scope exception does not apply**

Under this view, the paragraph 815-15-15-5 scope exception does not apply; it applies only to derivatives embedded in financial instruments. Instead, consistent with Example 13 (Case S) in Subtopic 815-15, a lessee should apply paragraph 815-15-15-10 to determine if an operating lease includes an embedded foreign exchange derivative. Depending on that evaluation, the lessee may or may not be required to bifurcate an embedded foreign exchange derivative. [815-15-15-10, 55-213 – 55-215]

Applying View B to the background example, Lessee LE would bifurcate an embedded foreign exchange derivative.

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## 2.2.2 Service concession arrangements



### Excerpt from ASC 853-10

> Entities

**15-2** The guidance in this Topic applies to the accounting by operating entities of a service concession arrangement under which a public-sector entity grantor enters into a contract with an operating entity to operate the grantor's infrastructure. The operating entity also may provide the construction, upgrading, or maintenance services of the grantor's infrastructure.

> The Operating Entity's Rights over the Infrastructure

**25-2** 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.

2.2.30 A service concession arrangement in the scope of Topic 853 is an arrangement between a public-sector entity grantor and an operating entity under which the operating entity operates the grantor's infrastructure (e.g. airports, roads and bridges) and may also provide construction, upgrade or maintenance services. [853-10-15-2]

2.2.40 Although there is no scope exclusion for service concession arrangements in Topic 842 itself, the consequential amendments to Topic 853 are explicit that the right to use the infrastructure in a service concession arrangement is not in the scope of Topic 842. [853-10-25-2]

## 2.3 In the scope of Topic 842

### 2.3.1 Non-core assets

2.3.10 Non-core assets, such as a corporate jet or an administrative office, are not used in an entity's primary operations. However, leases of non-core assets are not excluded from the scope of Topic 842.



#### Observation

##### Leases of non-core assets are in scope

2.3.20 The Board decided not to exclude non-core assets from the scope of Topic 842 for the following reasons. [\[ASU 2016-02.BC111–BC112\]](#)

- US GAAP does not distinguish core and non-core assets that are purchased (or otherwise acquired) for purposes of recognition and measurement; therefore, it would be inconsistent to create such a distinction for leased assets.
- Conceptually, the lease of a non-core asset creates no less of a ROU asset or lease liability than the lease of a core asset; the same thinking applies to non-core assets that an organization purchases on a financed basis.  
Excluding leases of non-core assets from the scope of Topic 842 would have left material ROU assets and lease liabilities unrecognized.

### 2.3.2 Long-term leases of land

2.3.30 The scope of Topic 842 does not exclude long-term leases of land (e.g. 99- or 999-year leases). Although there is an argument that such long-term leases are economically similar to the purchase or sale of land, the Board decided against a scope exclusion. This was principally because there is no conceptual basis for differentiating long-term leases of land from leases of other assets, and inevitably any definition of a long-term lease of land would be arbitrary. [\[ASU 2016-02.BC113\]](#)



#### Question 2.3.10

##### Land easements

### Are land easements in the scope of Topic 842?

**Background:** A land easement is, in general, a right to use and/or enter (or cross) land owned by another party for a specific purpose, for which the rights vary depending on the easement. Land easements may be perpetual or for a defined term, may be prepaid or paid over time, and may provide for exclusive or nonexclusive (shared) use of the land.

Land easements are used in a variety of industries, but are especially common in the energy, utilities, transportation and telecom industries. Pre-Topic 842, diversity in practice existed in the accounting for land easements. Some entities applied Topic 840, and others accounted for land easements under other guidance (e.g. as an intangible asset in the scope of Topic 350 or as part of the cost of property, plant or equipment in the scope of Topic 360). The view that a land easement is an intangible asset was based on Example 10 in Subtopic 350-30, which, before ASU 2018-01, described the perpetual land easements in that example as intangible assets without reference to evaluating whether the easements meet the definition of a lease. [350-30-55-29 – 55-32]

**Interpretive response:** Yes. The Board has affirmed that land easements are in the scope of Topic 842 because an easement is, by nature, a right to use identified property. Therefore, a land easement should be accounted for as a lease if it meets the definition of a lease. Land easements should be accounted for under other guidance (e.g. Topics 350 or 360) only if they do not meet the Topic 842 definition of a lease. Questions 3.1.10, 3.2.20 and 3.3.90 discuss relevant considerations for determining whether land easements meet the definition of a lease. [842-10-15-1]

To clarify that land easements cannot be accounted for as intangible assets unless they do not meet the Topic 842 definition of a lease, the Board issued ASU 2018-01, which amends Example 10 in Subtopic 350-30. The amendment clarifies that the perpetual easements in the example were first determined not to meet the definition of a lease *before* being accounted for as intangible assets.

#### Transition practical expedient

In ASU 2018-01, the Board also amended Topic 842 to provide a transition practical expedient that allows an entity to grandfather its accounting for land easements that commence before the effective date. Entities electing this expedient will continue to account for those land easements in the same manner as they did before adoption of Topic 842 until they expire, unless they are modified on or after the effective date. For further discussion, see sections 13A.2.4 and 13B.2.4.

### 2.3.3 Certain sales with repurchase rights – supplier's perspective

2.3.40 In addition to those transactions in the scope of Topic 842, some arrangements in the scope of Topic 606 or Topic 610 (other income), in which an entity sells a nonfinancial asset to another party, but with the right or obligation to repurchase that asset from the customer, are accounted for as leases by the supplier. [606-10-55-66 – 55-78, ASU 2014-09.BC427]

- **Forward or call option.** If an entity sells an asset and also has an obligation or a right to repurchase the asset, the entity accounts for the arrangement as a lease if it can or must repurchase the asset for an amount that is less than its original selling price. However, if a call option is non-substantive, it should be ignored; this is for consistency with the general requirement for any non-substantive term in a contract. [606-10-55-68, ASU 2014-09.BC427]

- **Put option.** If an entity sells an asset and also has an obligation to repurchase the asset at the customer's request, the entity accounts for the arrangement as a lease if the customer has a 'significant economic incentive' to require the entity to repurchase the asset. [606-10-55-72]

2.3.50 The Board's rationale for requiring these arrangements to be accounted for as leases by the supplier is that the combined effect of the sale and repurchase agreement in each case is that the entity does not transfer control of the asset to the customer. Instead, the arrangement merely permits the customer to control the use of the asset for a period of time (which may not be defined) in exchange for consideration. [ASU 2014-09.BC424–BC431]



### Question 2.3.20

#### **Sales of out-of-scope nonfinancial assets with a seller repurchase right or obligation**

**Should sales of assets, which if leased would be outside the scope of Topic 842, subject to a seller repurchase right or obligation be considered leases by analogy?**

**Interpretive response:** The repurchase agreements guidance in Topic 606 applies to the sale of any nonfinancial asset, which includes assets that, if leased, would be outside the scope of Topic 842 – e.g. intangible or biological assets.

Therefore, it is unclear whether the Board intends for entities in this scenario to analogize to the leases guidance for sales of such assets or whether those requirements do not apply to arrangements for the sale of such assets.



### Question 2.3.30

#### **Accounting for sales with repurchase rights by suppliers and customers**

**How might the accounting for sales with repurchase rights be different for suppliers vs. customers?**

**Interpretive response:** Topic 606 and Topic 610 do not apply to the customer in a sale transaction. Consequently, the customer in a sale transaction that will be accounted for as a lease by the supplier will not account for that transaction as a lease unless the arrangement meets the definition of a lease in Topic 842 (see chapter 3).

Customers will generally apply other guidance – e.g. Topic 360 (property, plant and equipment) or Topic 330 (inventory) – in determining whether, and how, to account for the purchase. Because there is limited guidance in US GAAP about whether a purchase of an asset has occurred, we believe customers in these arrangements with repurchase provisions may still conclude that they have

purchased the asset even if Topic 606 or Topic 610 requires the supplier to account for the transaction as a lease.



### Are heat supply contracts for nuclear fuel in the scope of Topic 842?

**Background:** Heat supply contracts, sometimes called 'burn up' contracts or nuclear fuel leases, are contracts that provide for payment by the user-lessee based on nuclear fuel usage in the period plus a charge for the unrecovered cost base.

**Interpretive response:** Topic 840 explicitly included heat supply contracts for nuclear fuel that meet the definition of a lease within the scope of the lease accounting requirements, while the guidance in Topic 842 does not. However, because we believe the scope of Topic 842 was intended to be consistent with that of Topic 840, and because nuclear fuel leases are not explicitly excluded from the scope of Topic 842, entities will have to consider whether such arrangements meet the definition of a lease (see chapter 3). [840-10-15-9, 55-7]

## 2.4 Differences/changes in scope

2.4.10 The Board decided to fundamentally retain the scope of the legacy leasing guidance in its new leasing guidance, which means that there are only minor differences in scope between Topic 842 and Topic 840. [IASU 2016-02.BC110]



### No major changes to the scope of the leases topic

2.4.20 The scope of Topic 842 is substantially the same as Topic 840. Both Topics' scopes include leases of tangible assets, long-term leases of land, subleases and sale-leaseback transactions.

### Sale of an asset with a seller-provided resale value guarantee

2.4.30 Before the adoption of Topic 606, arrangements in which the seller of an asset provided a guarantee of the asset's future resale value to the buyer were accounted for as leases by the seller, regardless of whether the buyer has to return the asset to the seller to receive a guarantee payment. [840-10-55-14 (before ASU 2014-09)]

2.4.40 Under Topic 842, a seller resale value guarantee does not necessarily preclude sale accounting by the seller, and therefore does not require the seller to account for the transaction as a lease. As a result, some arrangements

involving seller resale value guarantees that are accounted for as leases under Topic 840 will no longer be accounted for as leases once Topic 606 is adopted (see Question 7.2.10). [842-30-55-1 – 55-15]

2.4.50 An arrangement in which the seller has the right or the obligation (i.e. call option or forward) to reacquire the asset *may* be accounted for as a lease by the seller depending on the terms of the repurchase agreement. The arrangement would be accounted for as a lease if the seller can or must repurchase the asset for an amount that is less than the price at which the asset was sold (unless the contract is part of a sale-leaseback transaction). A vendor (or supplier) with an arrangement of this nature will need to consider the guidance in Topic 842 and the repurchase agreements guidance in Topic 606. [606-10-55-66 – 55-78]

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# 3. Definition of a lease

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**New item added in this edition: \*\***

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- 3.2.55 Substitution rights that do not exist throughout the period of use
- 3.2.60 Supplier's practical ability to substitute alternative assets
- 3.2.70 Substitution rights that are not economically beneficial throughout the period of use

### **Examples**

- 3.2.10 Assessing whether there is a physically distinct asset
- 3.2.15 Rooftop space asset identification
- 3.2.20 Substitution rights
- 3.2.30 Supplier substitution right – evaluation of economic benefits
- 3.2.40 Assessing what is (are) the identified asset(s)
- 3.2.50 Infrastructure-as-a-Service – identified assets
- 3.2.60 Implicitly specified land asset with substitution rights

### **Comparison to legacy US GAAP**

#### **3.3 Does the customer control the use of the identified asset?**

- 3.3.1 Step 1: What is the scope of the customer's right of use within the contract?
- 3.3.2 Step 2: What are the economic benefits from use of the identified asset?
- 3.3.3 Step 3: Does the customer have the right to obtain substantially all of the economic benefits from use of the identified asset?
- 3.3.4 Step 4: Does the customer have the right to direct the use of the asset?
- 3.3.5 Step 4: Control when the 'how and for what purpose' decisions are predetermined

### **Observations**

A lease is different from a service

Government priorities can drive whether there is a lease

Payment of portion of cash flows from an asset to the supplier (or another party)

'Relevant decisions' affect how and for what purpose an asset is used

Decisions about how and for what purpose the asset is used are predetermined in the contract

**Questions**

- 3.3.10 Relevance of the control concept in Topic 810
- 3.3.20 Contractual restrictions affecting whether or not there is a lease
- 3.3.30 Evaluating the substance of economic benefits from use
- 3.3.39 Analyzing economic benefits from use of an asset
- 3.3.40 Total economic benefits from use of an asset
- 3.3.42 Data about customer's use of the asset
- 3.3.45 Supplier use of the identified asset
- 3.3.50 Tax attributes
- 3.3.60 Meaning of 'substantially all'
- 3.3.70 Fixed economic return from use of an identified asset
- 3.3.80 Changes to the customer's right to obtain the economic benefits from use during the period of use
- 3.3.90 Time-based land easements
- 3.3.100 Operational decisions
- 3.3.110 Functional independence
- 3.3.120 Customer-premise identified assets dedicated to the customer
- 3.3.130 Leases when the supplier has physical possession of, operates and maintains the identified asset
- 3.3.140 Control over the use of pipeline laterals
- 3.3.150 Control over the use of identified 'last mile' assets
- 3.3.160 Evaluating the customer design criterion in renewable energy power purchase agreements

**Examples**

- 3.3.10 Right to obtain the economic benefits from use – outsourcing arrangement
- 3.3.20 Internet service agreement
- 3.3.30 Directing the use of identified assets – truck and trailers
- 3.3.40 Infrastructure-as-a-Service – control over the use of the identified asset
- 3.3.45 Supplier-owned fiber-optic telecommunications equipment – control over use \*\*
- 3.3.50 Construction services contract
- 3.3.55 Point-of-sale terminals – right to direct the use of the identified assets \*\*

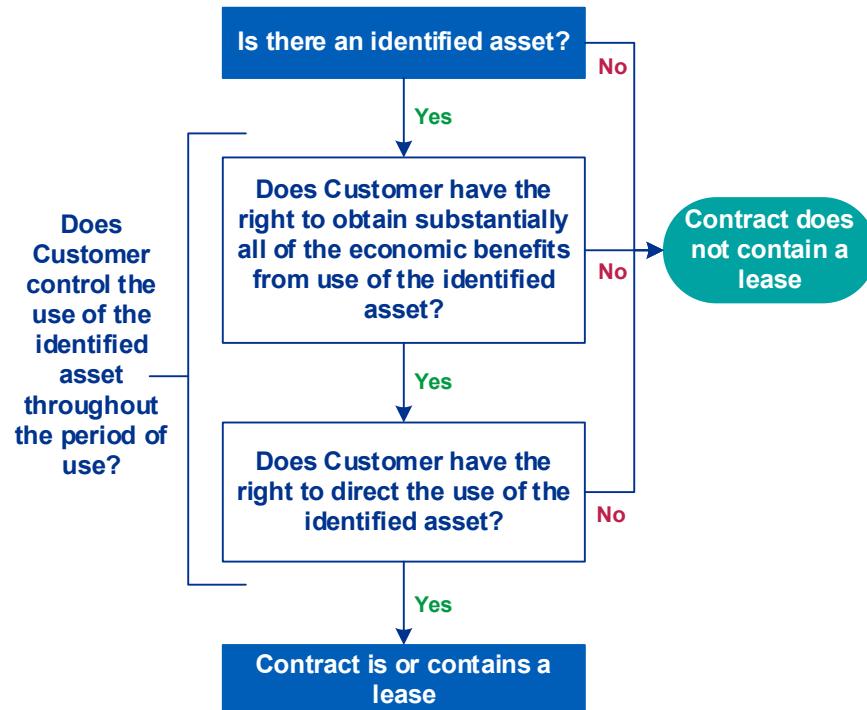
- 3.3.60 Right to direct the use of the identified asset – outsourcing arrangement
- 3.3.62 Construction subcontractor arrangement (1) – scaffolding
- 3.3.65 Right to direct the use of the identified asset – shipping spot charter
- 3.3.70 Right to direct the use of the identified asset – storage warehouse(s)
- 3.3.75 Right to direct the use of the identified asset – advertising on a bus
- 3.3.76 Right to direct the use of the identified asset – billboards
- 3.3.80 All relevant how and for what purpose decisions are predetermined – outsourcing arrangement
- 3.3.90 Right to direct the use of the identified asset is predetermined – storage warehouse
- 3.3.95 Construction subcontractor arrangement (2) – perimeter fencing
- 3.3.100 Outsourcing arrangement that was a lease under Topic 840 but is not under Topic 842

**Comparison to legacy US GAAP**

## How the standard works

An entity assesses at contract inception whether a contract is, or contains, a lease. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset (land or a depreciable asset) for a period of time in exchange for consideration.

The following are the key elements of the definition.



## 3.1 Overview



### Excerpt from ASC 842-10

#### 15 Scope and Scope Exceptions

##### General

> Identifying a Lease

**15-2** At inception of a **contract**, an entity shall determine whether that contract is or contains a **lease**.

**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:

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

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

**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.

**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.

**15-7** In making the determination about whether a contract is or contains a lease, an entity shall consider all relevant facts and circumstances.

**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.

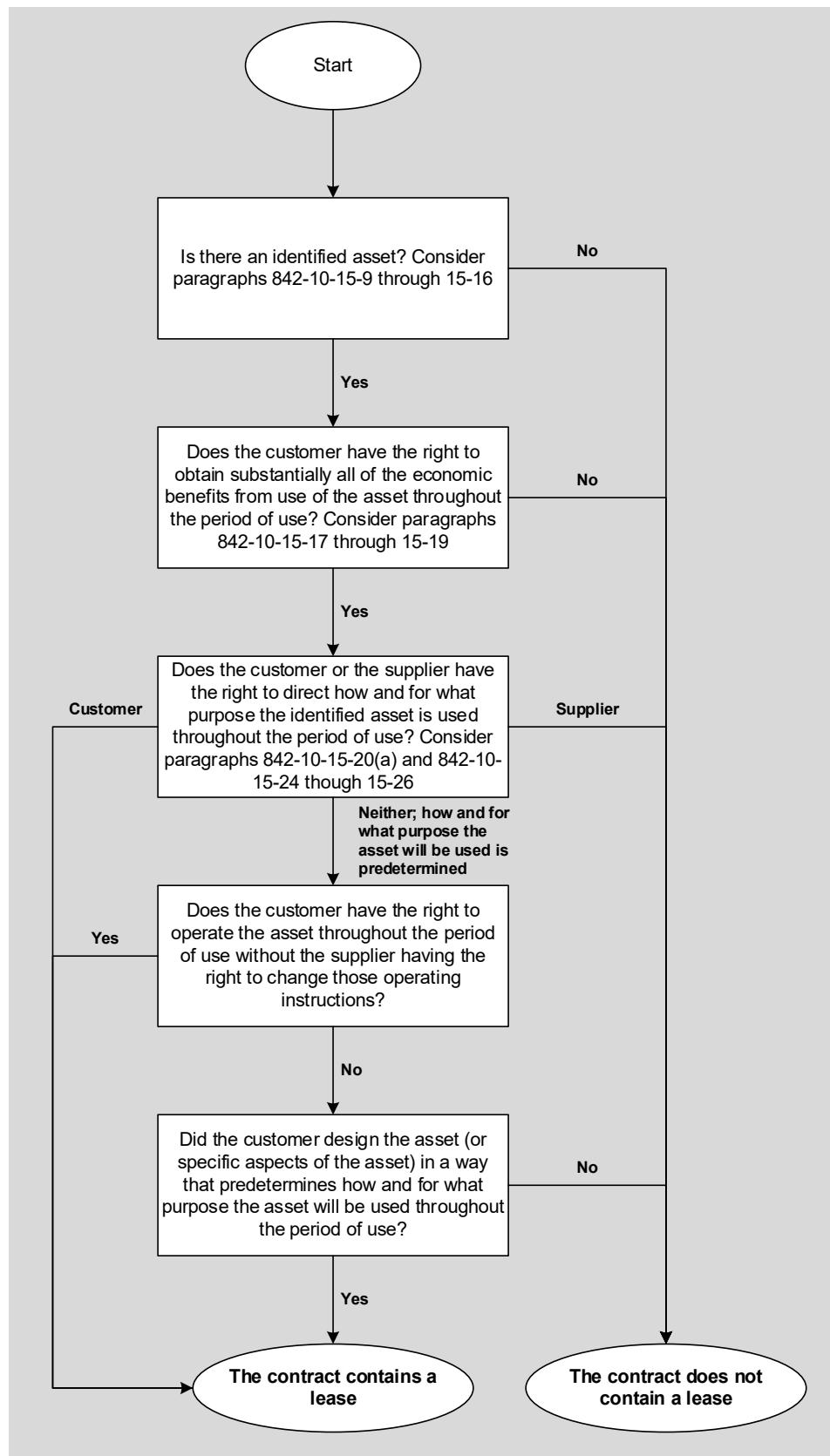
#### 55 Implementation Guidance and Illustrations

##### General

> Implementation Guidance

- > Identifying a Lease

**55-1** 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 it is not intended as a substitute for the guidance on identifying a lease in this Subtopic.



3.1.10 A lease is a contract (or part of a contract) that conveys the right to control the use of identified property, plant or equipment (an identified asset) for a period of time in exchange for consideration. A period of time may be described in terms of a specified amount of use of an identified asset. For example, the period of time a lessee will control the use of an identified asset may be defined in terms of the number of production units an item of equipment will be used to produce or a specific task (or tasks) the identified asset will complete – e.g. the lease of an oil drilling rig may be for the period of time necessary to drill a specified number of wells. [842-10-15-3]



## Question 3.1.10 **Perpetual land easements**

### **Does a perpetual land easement meet the definition of a lease?**

**Background:** A land easement is, in general, a right to use and/or enter (or cross) land owned by another party for a specified purpose, for which the rights vary depending on the easement. Land easements are used in a variety of industries, but are especially common in the energy (oil and gas), utilities, transportation (e.g. rail) and telecom industries.

For example, in the energy industry, a land easement may involve a grantor conveying rights to a grantee to pass a pipeline underneath or above specified farmland while allowing the grantor to continue farming the land. Alternatively, an easement may convey the right to pass an asset (e.g. a pipeline or fiber-optic cable) through an existing body of water or over a specified stretch of land. Land easements may be perpetual or for a defined term, and may be prepaid or paid over time.

As discussed in Question 2.3.10, land easements are in the scope of Topic 842 and therefore must be assessed to determine whether they meet the definition of a lease. Questions 3.2.20 and 3.3.90 address whether floating (or roving) land easements and time-based (i.e. non-perpetual) land easements, respectively, meet the definition of a lease.

**Interpretive response:** No. This is because a lease conveys the right to control the use of identified property, plant or equipment *for a period of time* in exchange for consideration. Because the right to use the land granted by the easement is perpetual, we believe it lacks an essential characteristic of a lease – i.e. that the grantee controls a right to use the land only for a period of time. Rather, a perpetual land easement is, in effect, a form of *ownership of a portion of the land*. Amended Example 10 in Section 350-30-55 and the basis for conclusions to ASU 2018-01 provide support for this view. [350-30-55-30, ASU 2018-01.BC13]



### Question 3.1.11\*\*

#### 'Evergreen' and 'pay-as-you-go' arrangements

##### **Do 'evergreen' and 'pay-as-you-go' arrangements qualify as perpetual arrangements?**

**Background:** An 'evergreen' arrangement typically refers to one that automatically renews on a day-to-day, week-to-week or month-to-month basis in perpetuity unless cancelled by either party.

A 'pay-as-you-go' arrangement may give the lessee the right to use the underlying asset indefinitely, but can be terminated by the lessee at any time.

The issue in both types of arrangements is similar to the issue with perpetual land easements (see Question 3.1.10). Is the arrangement perpetual such that it does not meet the definition of a lease because the grantee's right to use the identified asset is not '*for a period of time*'? [842-10-15-3]

**Interpretive response:** No. While evergreen and pay-as-you-go arrangements may exist into perpetuity or may give the lessee the right to renew in perpetuity, respectively:

- in evergreen arrangements, the rights of use are not perpetual because either party can terminate the arrangement and both parties' termination rights are economically substantive; while
- in pay-as-you-go arrangements, the rights and obligations of the parties are not perpetual because the lessee has an economically substantive option to terminate the lease by no longer making payments to the lessor.

For an arrangement to be perpetual, and therefore not meet the definition of a lease, we believe the contract must grant perpetual use rights for which neither party has a termination right or option that is economically substantive. In our view, a termination option held by the grantee is not economically substantive if it simply allows the grantee to abandon a perpetual right of use for which it has already paid the grantor without obtaining a commensurate refund.

Example 5.3.30 and the observation in paragraphs 5.3.110 – 5.3.130 provide guidance about determining the lease term for evergreen and pay-as-you-go lease arrangements.



### Question 3.1.20

#### Meaning of 'consideration'

##### **If there is no stated consideration in the contract for the right to use an identified asset or the consideration is noncash or in-kind, does that mean there is no lease?**

**Interpretive response:** No. The existence of a lease does not depend on there being stated consideration for the right to use the underlying asset or that the

consideration for the lease be in the form of cash. Sometimes consideration is either (or both) not stated in the contract or is noncash in nature.

For example, assuming the two conditions in paragraph 3.1.40 are met, a lease could exist in any of the following circumstances (not exhaustive).

- The only consideration stated in the contract is a per unit fee for consumables used in the operation of the underlying asset – i.e. there is no stated contractual consideration for the lease of the underlying asset.
- The customer will provide services to the supplier or pay in a commodity.
- The consideration for the lease is in-kind – i.e. the two entities exchange rights to use each other's assets – e.g. Entity A grants Entity B a right to use Entity A's land in exchange for a right to use Entity B's land.

3.1.20 Both parties to a contract (the customer and the supplier) evaluate at *inception* of the contract whether it is or contains a lease. An entity does not reassess whether a contract is or contains a lease unless the terms and conditions of the contract are changed. [842-10-15-2, 15-6 – 15-7]

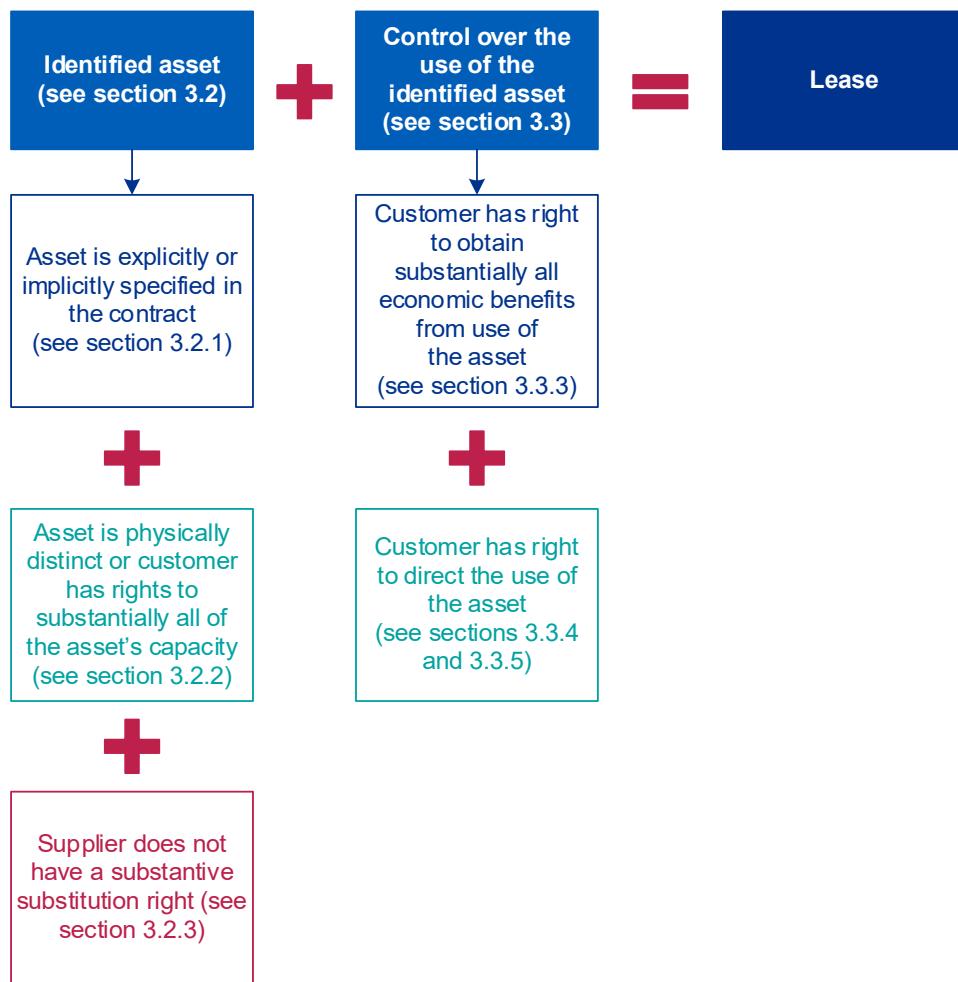


### Observation

#### **Leases are identified at contract inception**

3.1.30 Determining whether a contract is or contains a lease occurs at contract inception for practical reasons. Because Topic 842 uses the lease commencement date for recognition and measurement of a lease, while other Topics use different dates (e.g. Topic 606 measures and allocates the transaction price to performance obligations at contract inception), it is necessary to identify whether a contract includes one or more leases at contract inception to know whether the lease's recognition and measurement guidance applies, and if so, which guidance (i.e. Topic 842 and/or another Topic) governs.

3.1.40 The following diagram highlights the two conditions required to meet the definition of a lease, plus the specific tests that must be passed to meet those conditions, which are discussed in this chapter.



3.1.50 To meet the definition of a lease under Topic 842:

- there must be an identified asset in the contract that is land or a depreciable asset – i.e. property, plant or equipment; and
- the customer must have the right to control the use of the identified asset.



### Observation

**Lease definition similar but not the same**

3.1.60 While the two conditions in paragraph 3.1.50 appear similar to the requirements for identifying a lease under Topic 840, important details have changed.

3.1.70 Most notably, the second condition (i.e. the customer must have the right to control the use of the identified asset) is now more closely aligned with how control is defined and applied in Topic 810 (consolidation) and Topic 606. This is because, while an entity had to consider the customer's right to obtain the output or other utility from use of the identified asset under Topic 840 (which is similar to evaluating the customer's right to obtain the economic benefits from

use of the underlying asset under Topic 842), the concept of evaluating whether the customer has the right to direct the use of the identified asset (a ‘power’ element of control) is new to Topic 842.

3.1.80 In most cases, a customer will have the right to direct the use of an identified asset if it can direct (and change) ‘how and for what purpose’ the asset will be used throughout the ‘period of use’ (see section 3.3.4). However, if how and for what purpose the asset will be used is determined before the beginning of the period of use (e.g. predetermined in the contract or by the design of the asset), a customer still directs the use of the asset if it has either (1) operational control over the asset, or (2) had control over the design of those aspects of the asset that predetermine how and for what purpose it will be used (see section 3.3.5).



### Observation

#### A straightforward analysis in most cases

3.1.90 In the Board’s view, assessing whether a lease exists will be straightforward in most cases. A contract will either fail to meet, or will clearly meet, the definition of a lease without the need for significant judgment. The new definition will likely continue to easily capture most common lease arrangements – e.g. leases of vehicles, office equipment and real estate.

3.1.100 However, for more complicated scenarios, the Board added guidance to assist entities in their evaluations. Examples of more complicated lease identification scenarios may include some outsourcing arrangements, and other arrangements in which both the customer and the supplier have decision-making rights about the use of an asset. This includes some equipment arrangements where the customer makes most or all of the decisions about how and for what purpose the asset will be used (see section 3.3), but the supplier retains the decision-making rights over operations and/or maintenance of the equipment. [IASU 2016-02.BC127]

3.1.110 Determining whether a contract is or contains a lease is an important step under Topic 842. When a contract is or contains a lease, the core principle of Topic 842 is that the customer (lessee) should recognize both a lease liability for its obligation to make lease payments to the supplier (lessor) and an ROU asset reflecting its right to use the underlying asset during the lease term. Whether a contract is or contains a lease also triggers specific disclosure requirements for lessees and lessors. Consequently, properly identifying leases is important to all entities, regardless of their role as customer or supplier in the arrangement.



## Observation

### **Lease definition is the new on-/off-balance sheet test**

3.1.120 Under Topic 840, the critical determination in lessee accounting was lease classification, because lease assets and lease liabilities were recognized only for capital leases. In contrast, under Topic 842 a lessee recognizes lease assets and lease liabilities for all leases other than 'short-term leases' (see section 6.3.1), whether classified as operating or finance leases. Lease identification is therefore the new test to determine whether an arrangement is on- or off-balance sheet for the customer. While the lease classification distinction continues to exist in Topic 842, it now affects how lessees measure and present lease expense and cash flows – not whether the lease is on- or off-balance sheet.

3.1.130 Throughout this chapter, the 'period of use' is referred to in looking at the economic benefits to which the customer has rights, and the customer's power to control the use of the asset. The period of use is the total period of time that an asset is used to fulfill a contract with a customer, including the sum of any non-consecutive periods of time. [\[842 Glossary\]](#)



## Question 3.1.30

### **When to determine the 'period of use'**

#### **Is the 'period of use' determined before assessing whether there is an identified asset and whether the customer controls the use of an identified asset?**

**Interpretive response:** Yes. The 'period of use' is determined *before* assessing whether the two conditions in paragraph 3.1.40 are met; the period of use is, in effect, an input to lease identification. This is because, for example:

- for there to be a lease, a customer must have both (1) the right to obtain substantially all of the economic benefits from use (see section 3.3.3), and (2) the right to direct the use of an identified asset throughout the period of use (see section 3.3.4).
- for a supplier substitution right to be substantive, and therefore result in a conclusion that there is not an identified asset, the supplier must have that right throughout the period of use (see section 3.2.3).

Because the period of use is used to evaluate *whether* the two conditions in paragraph 3.1.40 are met, if the period of use were also considered to be the period of time that these conditions are met, the definition of a lease would be circular. Therefore, the period of use is established *before* concluding whether a lease exists.

We do not believe the definition of period of use refers to the total period of time that an *identified* asset is used to fulfill a contract with a customer. Instead, the period of use merely refers to the period of time, potentially within

a longer overall contract term, that an item of property, plant or equipment is necessary to fulfill the contract. For example, even though Example 1 Case B and Example 2 in Subtopic 842-10 both conclude that there is not an 'identified asset' (i.e. no lease exists), the periods of use in those examples are five years and three years, respectively. The five- and three-year periods are the periods of use in each example because they represent the periods of time during which rail cars (Example 1 Case B) and physical floor space within the airport (Example 2) – i.e. items of property, plant or equipment – will be used to fulfill the contract with the customer. [842-10-55-48 – 55-54]

Paragraph 3.2.140, and Questions 3.2.55 and 3.3.80 address specific application issues related to the interaction of the period of use with the lease identification criteria in paragraph 3.1.40.



### Question 3.1.40

#### Period of use vs. contract term

**For a lease to exist, must the customer have the right to control the use of an identified asset throughout the term of the contract that contains the potential lease?**

**Interpretive response:** Not necessarily. For a lease to exist, the customer must have the right to control the use of (see section 3.3) the identified asset (see section 3.2) throughout the 'period of use'. Period of use is a defined term in Topic 842 that may be different from the overall contract term.

Because of how period of use is defined and used in the guidance on identifying a lease, an arrangement to use or that depends on an identified asset would not fail the definition of a lease solely because it is either contained within a contract with a longer overall term than the period of use, or contains intermittent periods during the contract term during which the customer does not have the right to control the use of the asset.

For example, a sports team that has the right to use an identified stadium for the months of September through January each year (during its playing season) for a period of 10 years would have a lease if it has the right to control the use of the stadium during the 10 five-month periods, even though it does not have the right to control the use of the stadium during the other seven months each year of the 10-year term of the contract. The period of use when evaluating control is the 50 non-concurrent months. Similarly, a 10-year service contract can contain a lease regardless of the fact that it involves the supplier granting the customer the right to use an identified asset for only the first five years of that contract – e.g. until the customer builds its own asset that will be used in fulfilling the arrangement.

### 3.1.1 Joint operating agreements

3.1.140 Entities often enter into joint arrangements in the normal course of business. A joint arrangement, which may or may not be a legal entity, is considered to be the customer when assessing whether a lease exists, and in accounting for the lease, when the contract is:

- entered into by the joint arrangement itself – e.g. if the joint arrangement is a legal entity, such as a joint venture;
- entered into by all of the parties to the joint arrangement; or
- signed by one or more of the parties to the joint arrangement expressly on behalf of (i.e. as an agent of) the joint arrangement.

3.1.150 Provided that one or more of the above conditions are met, the joint arrangement, and not the individual parties to the joint arrangement, is considered to be the customer when assessing whether the contract contains a lease. In this situation, it would not be appropriate to conclude that a contract does not contain a lease on the grounds that the parties to the joint arrangement, individually:

- only obtain a capacity portion of the asset that is not physically distinct;
- only obtain a portion of the economic benefits from use of the asset; or
- do not have the right to direct the use of the asset.

3.1.160 When the joint arrangement is the customer, the contract contains a lease if the parties to the joint arrangement collectively have the right to control the use of an identified asset throughout the period of use – e.g. a joint operating committee makes the relevant decisions about how to deploy the asset. [842-10-15-4]

3.1.170 A joint arrangement is frequently not a legal entity, rather it is simply a joint operating agreement (JOA) between two or more legal entities. And typically, the individual parties do not jointly enter into the contract with the asset supplier and the supplier may have no knowledge of the joint arrangement. Rather, one party assumes the role of operator of the JOA and is the primary obligor to the contract with the asset supplier. In those cases, the rights of the operator are considered in determining if there is a lease and, if there is a lease, the operator will be the lessee.

3.1.180 If a lease exists and the operator of the JOA is determined to be the lessee, a sublease may exist between the operator and the JOA – i.e. the operator may surrender its right to control the use of the underlying asset to the JOA – and this may be the case even if the JOA controls the use of the asset for only a portion of the operator's lease term. The operator would account for the sublease in the same manner as it would any other sublease (see chapter 8), with the exception that the operator's accounting for the sublease would be restricted to the other parties' share in the JOA because the operator cannot record a sublease to itself, while the accounting by the parties to the JOA may differ depending on industry-specific US GAAP – e.g. pro rata consolidation guidance in the oil and gas industry.

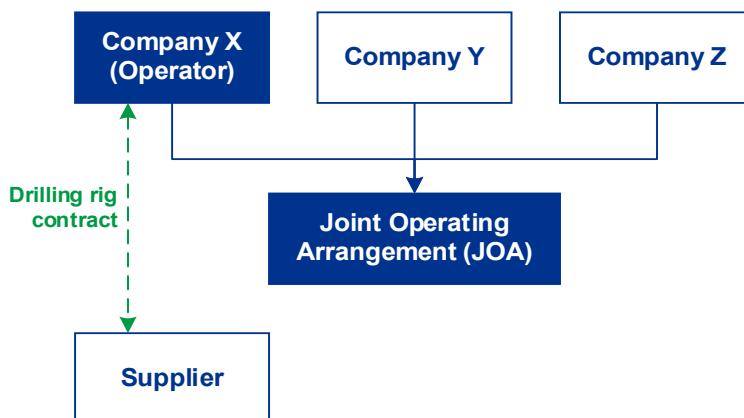


### Example 3.1.10 Oil drilling joint operation

Companies X, Y and Z enter into a joint operating agreement (JOA) to explore a mineral interest. Company X is appointed as the operator of JOA – i.e. Company X manages the day-to-day operations of JOA – while Companies Y and Z are non-operators.

Company X, in its own name, enters into a four-year contract with Supplier for the use of a drilling rig necessary for exploration activities. The drilling rig is explicitly specified in the contract and Supplier has no substitution rights. Supplier is responsible for manning, maintenance and safety of the rig. In accordance with the contract, Company X makes all decisions about when and where to use the rig, including which geological targets to test.

Company X is involved in a number of projects at various stages of development. Company X allocates the drilling rig to JOA for an initial two-year period, after which Company X has it earmarked for another, unrelated project.



Company X is the customer to the contract with Supplier because Company X enters into the contract and the contract grants Company X, not JOA, the rights to use the rig. The contract contains a lease because:

- the drilling rig is an identified asset – i.e. it is specified in the contract and Supplier does not have the right to substitute the asset during the four-year contract term;
- Company X has the right to obtain substantially all of the economic benefits from using the drilling rig – by using it to explore its mineral interests and obtaining reimbursements from Companies Y and Z for their share of the costs; and
- Company X has the right to direct the use of the rig because it can decide when, where and how to use the rig.

Company X is the lessee of the drilling rig lease with Supplier. Consequently, Company X recognizes the entire ROU asset and lease liability on its balance sheet.

In addition, Company X will need to determine whether it has entered into a sublease of the drilling rig with JOA, in which Company X would be the sublessor and JOA the sublessee. When determining whether there is such a sublease, JOA (including Company X's share in JOA) is assessed as the customer. A sublease from Company X to JOA would exist if Company X conveys its right to control the use of the drilling rig to JOA. For example, Company X may convey to JOA (via a joint operating committee comprising representatives of Companies X, Y and Z) the right to decide when, where and how to use the rig.

- If there is a sublease, then Company X would apply lessor accounting for the sublease. However, unlike the evaluation of whether there is a sublease, lessor accounting for the sublease would be restricted to Company Y's and Company Z's share in JOA because Company X cannot record a sublease to itself. Companies Y and Z would account for their respective shares in the sublease between Company X and JOA.
- If there is not a sublease (e.g. because there is no collective control over the rig during the two-year period), then Company X (as receiver) and Companies Y and Z (as payers) would account for reimbursements related to the drilling rig in accordance with other GAAP – e.g. Topic 808 (collaborative arrangements).

### 3.1.2 Common control arrangements



#### Excerpt from ASC 842-10

> Identifying a Lease

**15-3A** As a practical expedient, an entity that is not 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; or an employee benefit plan that files or furnishes financial statements with or to the U.S. Securities and Exchange Commission may use the written terms and conditions of a related party arrangement between entities under common control to determine whether that arrangement is or contains a lease. For purposes of determining whether a lease exists under this practical expedient, an entity shall determine whether written terms and conditions convey the practical (as opposed to enforceable) right to control the use of an identified asset for a period of time in exchange for consideration. If an entity determines that a lease exists, the entity shall classify and account for that lease on the basis of those written terms and conditions. An entity may elect the practical expedient on an arrangement-by-arrangement basis.

**15-3B** If no written terms or conditions exist, an entity shall not apply the practical expedient in paragraph 842-10-15-3A. Rather, the entity shall determine whether the related party arrangement between entities under common control is or contains a lease in accordance with paragraph 842-10-15-3 and, if so, classify and account for that lease on the basis of its legally enforceable terms and conditions in accordance with paragraph 842-10-55-12.

**15-3C** If after an entity has applied the practical expedient in paragraph 842-10-15-3A an arrangement is no longer between entities under common control, the entity shall determine whether a lease exists in accordance with paragraph 842-10-15-3.

- a. If the arrangement was previously determined to be a lease and continues to be a lease, the entity shall classify and account for the lease on the basis of the enforceable terms and conditions. If the enforceable terms and conditions differ from the written terms and conditions previously used to apply paragraph 842-10-15-3A, the entity shall apply the modification requirements in paragraphs 842-10-25-9 through 25-17 using the enforceable terms and conditions. If the enforceable terms and conditions are the same as the written terms and conditions previously used to apply paragraph 842-10-15-3A, the modification requirements in those paragraphs are not applicable.
- b. If the arrangement was previously not determined to be a lease and is determined to be a lease, the entity shall account for the arrangement as a new lease.
- c. If the arrangement was previously determined to be a lease and the lease ceases to exist:
  1. A **lessee** shall apply the derecognition requirements for fully terminated leases in paragraph 842-20-40-1.
  2. A lessor with a lease previously classified as a sales-type lease or a direct financing lease shall apply the derecognition requirements for terminated leases in paragraph 842-30-40-2.
  3. A lessor with a lease previously classified as an operating lease shall derecognize any amounts that would not exist if the arrangement was not accounted for as a lease and account for the arrangement in accordance with other generally accepted accounting principles (GAAP).

3.1.190 For arrangements that exist between related parties under common control, an entity may elect, on an arrangement-by-arrangement basis, a practical expedient to use the written terms and conditions of a common control leasing arrangement (without regard to enforceability) to determine whether a lease exists and, if so, the classification of and accounting for that lease. This practical expedient is available to an entity that is not: [842-10-15-3A]

- 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; or
- an employee benefit plan that files or furnishes financial statements with or to the US Securities and Exchange Commission.

3.1.195 Question 4.4.17 addresses changes to an entity's election of a practical expedient, including the practical expedient in paragraph 3.1.190.

3.1.200 If the written terms and conditions convey the practical (as opposed to enforceable) right to control the use of an identified asset for a period of time in exchange for consideration, the entity classifies and accounts for that lease on the basis of those written terms and conditions. [842-10-15-3A]

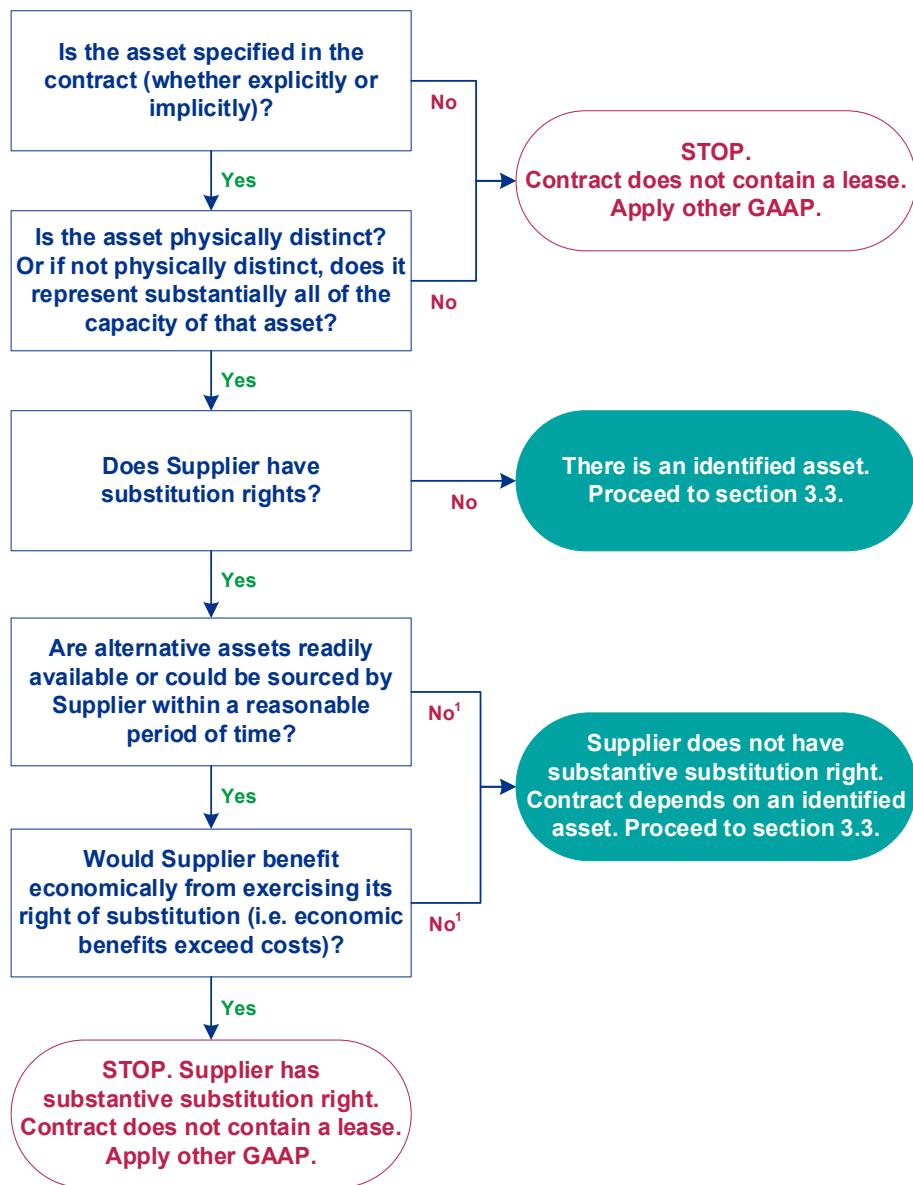
3.1.210 If there are no written terms and conditions, the entity cannot use the practical expedient; instead, it identifies the legally enforceable terms and conditions to determine whether a lease exists and, if so, uses those terms and conditions in applying Topic 842. [842-10-15-3B]

3.1.220 If an arrangement to which the practical expedient has been applied ceases to be between entities under common control, the entity is no longer allowed to use the practical expedient to account for the arrangement. The following table highlights the accounting. [842-10-15-3C]

Fact pattern	Accounting
When applying the practical expedient, the arrangement was determined to be (or contain) a lease and continues to be a lease.	The enforceable terms and conditions <b>are the same</b> as the written terms and conditions previously used.
	The legally enforceable terms and conditions <b>are not the same</b> as the written terms and conditions previously used.
When applying the practical expedient, the arrangement was determined to be a lease and is now determined <b>not</b> to be a lease.	The entity is a <b>lessee</b> .  The entity applies the lease modification guidance. See sections 6.7 (lessee) and 7.6 (lessor).
	The entity is a <b>lessor</b> .  A <b>lessee</b> applies the derecognition requirements for fully terminated leases. See section 6.8.  A <b>lessor</b> with a lease previously classified as a <b>sales-type or direct financing lease</b> applies the derecognition requirements for terminated leases. See paragraphs 7.3.440 and 7.3.450.  A <b>lessor</b> with a lease previously classified as an <b>operating lease</b> derecognizes any amounts that would not have existed if the arrangement was not accounted for as a lease and prospectively accounts for the arrangement in accordance with other US GAAP.
When applying the practical expedient, the arrangement was determined <b>not</b> to be a lease and is now determined to be a lease.	The entity accounts for the arrangement as a new lease.

## 3.2 Is there an identified asset?

The following flowchart takes the diagram in paragraph 3.1.40, and highlights in greater detail the key considerations in determining whether there is an identified asset – i.e. whether the first requirement for there being a lease is met. [842-10-15-9 – 15-16]



Note:

1. Or it is impractical for the customer to make this determination.



## Question 3.2.10

**Identified asset vs. separate lease components****Is the unit of account for lease identification each separate lease component or each identified asset?**

**Interpretive response:** Each identified asset. Paragraph 842-10-15-28 states, "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." Therefore, an entity identifies the leases that exist before identifying which leases are separate lease components.

In discussions about the guidance in paragraph 842-10-15-28, the FASB staff stated that an entity should not evaluate whether components of a single, integrated asset are separate leased assets. That is, an entity does not 'break apart' a single, integrated asset such as an airplane, a ship or a building and evaluate lease identification for the assets that were integrated to create the single asset. The FASB staff observed that Examples 6 to 9 in Subtopic 842-10 evaluate whether or not there is a lease for the ship, the aircraft, the factory and the power plant, respectively, rather than for the components of those assets.  
[\[842-10-55-79 – 55-123\]](#)

Conversely, in Example 10 Case A of Subtopic 842-10 (substantially the same as Example 3.2.50), the multiple servers are not a single, integrated asset (each server is a conventionally separable asset) such that each server could be an identified asset. Consistent with the preceding paragraph however, an entity would not evaluate whether the components of each server (e.g. the processors and the chipset) are leased assets. [\[842-10-55-124 – 55-126\]](#)

Accordingly, we believe the intent of the lease identification guidance in Topic 842 is to evaluate assets that can be sold, used or re-leased in their present form (e.g. computer servers, cars, aircraft), and not to evaluate assets that, as a result of their integration with other assets, would require substantial re-work to be sold, used or re-leased – e.g. separation from the other assets with which they are integrated.

**3.2.1 Is the asset specified in the contract?****Excerpt from ASC 842-10**

- > Identified Asset

**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.

3.2.10 An identified asset may be explicitly or implicitly specified in a contract. In most cases, the asset that is the subject of the lease will be explicitly specified in a contract – e.g. by serial number, or a specified floor of a building. In that case, there is an identified asset unless the supplier has a substantive right to substitute the specified asset (see section 3.2.3). [842-10-15-9]

3.2.20 An asset is implicitly specified in a contract if fulfillment of the contract depends on an item of property, plant or equipment (e.g. a piece of equipment) and the supplier does not have a substantive right to substitute alternative assets to fulfill the contract – e.g. the supplier has only one piece of equipment or facility to fulfill the contract. [842-10-15-9, ASU 2016-02.BC128]

3.2.30 An asset can be implicitly specified even if the customer does not know whether the supplier has multiple assets or only one asset to fulfill the contract – i.e. whether the supplier has the practical ability to substitute an alternative asset. For there to be an identified asset, an entity only needs to conclude that fulfillment of the contract depends on an item of property, plant or equipment (e.g. a piece of equipment) and that substitution of that asset would not be economically beneficial to the supplier or that there isn't enough information to make the determination as discussed in paragraph 3.2.40. [ASU 2016-02.BC128]

3.2.40 If the customer cannot readily determine either whether substitution would be (1) practicable or (2) economically beneficial to the supplier, the customer should assume any substitution right is not substantive. [842-10-15-15]



### Question 3.2.20

#### Floating (or roving) easements

#### Is there an identified asset when a property owner grants a floating (or roving) easement?

**Background:** A floating (or roving) easement exists when there is no fixed location, method, route or limit to the right of way. For example, a right of way may cross a field, without any specified or discernible path, or permit exit through another structure for evacuation purposes. A floating easement may, however, become fixed after a period of time or a specified event – e.g. the initiation of construction.

**Interpretive response:** In general, no. We believe it is acceptable to conclude that a floating (or roving) easement does not meet the definition of a lease because there is no identified asset. The absence of a fixed location, method, route or limit means no item of property, plant or equipment is explicitly specified in the contract between the grantor and the grantee. Meanwhile, assuming there are alternate locations, methods, routes or limits – e.g. multiple possible paths through which to exit a building or multiple paths through a field – no physically distinct piece of land is implicitly specified either.

We do not believe it would be consistent with the other guidance on identifying assets, such as that in Example 2 in Subtopic 842-10 on airport concession space, to consider the entire field or building (i.e. where the floating easement grants multiple possible paths through the field or paths of egress through the

building) as the identified asset. However, even if the entire field or building were the identified asset, it may frequently be the case that a lease would still not exist because the grantee does not have the right to obtain substantially all the economic benefits from use, or direct the use, of that entire identified asset. [842-10-55-52 – 55-54]

If a particular piece of land subject to an easement becomes specified – e.g. the path/route a pipeline or telecommunications conduit will transit becomes fixed once it is installed or when construction/installation starts and therefore specifies the path/route – the easement ceases to be floating (or roving). In that case, Questions 3.1.10 and 3.3.90 for perpetual and time-based easements, respectively, should be considered.

### 3.2.2 Is the asset physically distinct?



#### Excerpt from ASC 842-10

- • > Portions of Assets

**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.

#### 55 Implementation Guidance and Illustrations

##### General

- > Illustrations
- > Illustration of Identifying a Lease
- • > Example 3—Fiber-Optic Cable
- • • > Case A—Contract Contains a Lease

**55-55** Customer enters into a 15-year contract with a utilities company (Supplier) for the right to use 3 specified, physically distinct dark fibers within a larger cable connecting Hong Kong to Tokyo. Customer makes the decisions about the use of the fibers by connecting each end of the fibers to its electronic equipment (for example, Customer “lights” the fibers and decides what data and how much data those fibers will transport). If the fibers are damaged, Supplier is responsible for the repairs and maintenance. Supplier owns extra fibers but can substitute those for Customer’s fibers only for reasons of repairs, maintenance, or malfunction (and is obliged to substitute the fibers in these cases).

**55-56** The contract contains a lease of dark fibers. Customer has the right to use the 3 dark fibers for 15 years.

**55-57** There are three identified fibers. The fibers are explicitly specified in the contract and are physically distinct from other fibers within the cable. Supplier cannot substitute the fibers other than for reasons of repairs, maintenance, or malfunction.

**55-58** Customer has the right to control the use of the fibers throughout the 15-year period of use because:

- a. Customer has the right to obtain substantially all of the economic benefits from use of the fibers over the 15-year period of use. Customer has exclusive use of the fibers throughout the period of use.
- b. Customer has the right to direct the use of the fibers. Customer makes the relevant decisions about how and for what purpose the fibers are used by deciding when and whether to light the fibers and when and how much output the fibers will produce (that is, what data and how much data those fibers will transport). Customer has the right to change these decisions during the 15-year period of use.

**55-59** Although Supplier's decisions about repairing and maintaining the fibers are essential to their efficient use, those decisions do not give Supplier the right to direct how and for what purpose the fibers are used. Consequently, Supplier does not control the use of the fibers during the period of use.

••• > Case B—Contract Does Not Contain a Lease

**55-60** Customer enters into a 15-year contract with Supplier for the right to use a specified amount of capacity within a cable connecting Hong Kong to Tokyo. The specified amount is equivalent to Customer having the use of the full capacity of 3 strands within the cable (the cable contains 15 fibers with similar capacities). Supplier makes decisions about the transmission of data (that is, Supplier lights the fibers and makes decisions about which fibers are used to transmit Customer's traffic and about the electronic equipment that Supplier owns and connects to the fibers).

**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.

3.2.50 In most cases, the asset will be a complete asset and therefore easy to identify – e.g. a building or a piece of equipment. However, a capacity portion of an asset can also be an identified asset if: [842-10-15-16]

- it is physically distinct – e.g. the floor of a building, a specified strand of a fiber-optic cable, or a distinct segment of a pipeline; or
- it is not physically distinct, but the customer has the right to receive substantially all (see Question 3.3.60) of the capacity of the asset – e.g. substantially all of the data capacity of a fiber-optic cable.



## Observation

### **Most capacity portions are not identified assets**

3.2.60 In deciding on the requirements in paragraph 3.2.50, the Board reasoned that a customer is unlikely to have the right to control the use of a capacity portion of an asset that is not physically distinct or that is less than substantially all of the capacity of the asset, because the relevant decisions about an asset's use are generally made at the whole asset level. That is, having rights to only a capacity portion of an asset (that is not substantially all of the asset's capacity), a customer will generally not have decision-making rights as to how the asset is used. [ASU 2016-02.BC133]

3.2.70 Therefore, the Board decided not to broaden the concept of an identified asset to the use of any capacity portion of a larger asset, because it may have forced entities to analyze all contracts for goods or services in which a customer obtains some amount of capacity from an asset as possible leases, only to then conclude that they were not leases because the customer does not have the relevant decision-making rights about the asset's use. [ASU 2016-02.BC133]



## Example 3.2.10

### **Assessing whether there is a physically distinct asset**

#### **Scenario 1: Rights to a capacity portion – not physically distinct**

Customer enters into an arrangement with Supplier for the right to store its products in a specified climate-controlled storage warehouse (storage warehouse 3C).

Supplier has no substitution rights. However, the arrangement allows Supplier to store products from other customers in storage warehouse 3C. The exact space to be used by Customer within storage warehouse 3C is not specified. Instead, Supplier decides where each customer's products are stored within storage warehouse 3C and can relocate them at its sole discretion.

At inception of the contract, Customer has storage rights that permit it to use up to 60% of the capacity of storage warehouse 3C throughout the term of the contract. Supplier can use the other 40% of the warehouse as it sees fit.

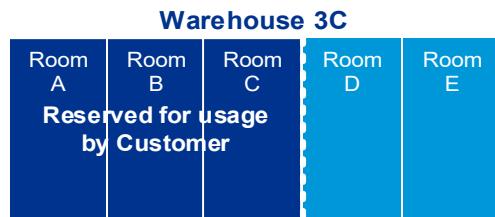


In this scenario, there is not an identified asset because Customer has rights only to a capacity portion of storage warehouse 3C that is not physically distinct from the remainder of the warehouse. In addition, the capacity of the storage

warehouse that Customer has the right to use does not represent substantially all of the capacity of storage warehouse 3C. Because there is not an identified asset, the contract does not contain a lease.

### Scenario 2: Rights to a capacity portion – physically distinct

Changing the facts of Scenario 1, the contract provides Customer the right to use rooms A, B and C within storage warehouse 3C, and Supplier has no substantive right to substitute alternative space in place of rooms A, B and C. Rooms A, B and C represent only 60% of storage warehouse 3C's total capacity.



In this scenario, there is an identified asset even though rooms A, B and C represent only 60% of storage warehouse 3C's total capacity. This is because the rooms are specified in the contract, are physically distinct from other storage locations within the warehouse and Supplier has no substantive substitution right.

Accordingly, the next step is for Customer to determine whether it has the right to control the use of rooms A, B and C (see section 3.3) to determine if there is a lease.



### Is the 'last mile' of a single, contiguous asset a physically distinct asset?

**Background:** Paragraph 842-10-15-16 is explicit that a segment of a pipeline that connects a single customer to the larger pipeline (i.e. a pipeline 'lateral') is a physically distinct asset (see paragraph 3.2.50). At a May 2017 public meeting, FASB members confirmed their view that a pipeline segment, which is constructed off of a main (or primary) pipeline, is a physically distinct asset under Topic 842; see Question 3.3.140 for considerations relative to whether such laterals meet the definition of a lease.

There are other circumstances in which the end (e.g. the last mile) of a single, *contiguous* asset serves only a single customer. For example, a train track may terminate at a customer location (e.g. a distribution center or manufacturing facility) such that the portion of the track from that customer's location to the next stop on the track, even if not physically separable, exclusively serves the customer (i.e. transports its goods or supplies). Alternatively, the end of a power or telephone line to a house or to a single-tenant facility may only carry power or signal to the resident/tenant of that house or facility.

**Interpretive response:** It depends. In general, we believe the last mile of a single, contiguous asset like those discussed in the background is itself a physically distinct asset only if it is mechanically separable from the remainder of the asset – e.g. if there is a switch that would permit a train to turn away from the last mile without transiting it, or a breaker that permits an entity to shut off the flow of electricity or signal to a power or telephone line.

If there is no mechanical separation, the last mile is not physically distinct from the remainder of the larger asset and cannot be an identified asset that is leased.

If the last mile is mechanically separable such that it is physically distinct, there will typically be an identified asset because the supplier will generally not have a substantive substitution right – i.e. the supplier will typically not have the practical ability to substitute the last mile asset and would not economically benefit from doing so even if practicable.

Question 3.3.150 addresses considerations about whether the customer controls the use of an identified last mile asset.



### Question 3.2.40 An asset's primary use

#### Does an asset's primary use affect whether a lease exists?

**Background:** Entities frequently permit other entities to share use of their property, plant and equipment. For example, an asset owner or lessee may permit another entity to place an advertisement on the side of its owned or leased building, vehicle (e.g. a bus), or shelter (e.g. a bus stop shelter). Similarly, a utility company may permit another entity to attach its wires or equipment to the utility company's pole or antenna.

In either case, an entity may conclude that the primary use of the asset is its function as a building, mode of transportation or shelter – or as a means for the utility company to provide its core service (e.g. providing electricity or telecommunications services) – and that the asset's ability to provide a space for advertising or for other entities to attach their wires/cables is a secondary use.

**Interpretive response:** It depends. Influencing our consideration of this question is our awareness that the Boards discussed the concept of primary versus secondary use during deliberations of Topic 842, and we understand they decided that whether the customer's use of an asset was its primary or a secondary use should not be determinative as to whether there is a lease. But although not determinative, we believe consideration of an asset's primary use may be relevant in some cases when identifying the asset (i.e. the item or portion of property, plant or equipment) that should be evaluated.

Consider an arrangement between a cable television provider and an electric utility whereby the cable company will pay for the right to attach its cable wires to the utility's distribution poles – used for hanging the utility's electrical wires to transport electricity to its customers – for seven years. The specific spot on

each pole may not be explicitly specified (although there may be a requirement that the cables are attached only above a certain height and/or are not attached to the top of the utility poles). Regardless, the spots may be implicitly specified once the cables are attached, and because the utility company generally will not economically benefit from disconnecting and then reattaching the cables to a different spot on the utility pole, the implicitly specified spot on the pole is an identified asset (see paragraph 3.2.30). Therefore, one view is that the specific spot on each utility pole where the cable is attached is an identified asset that the cable company may control the use of (see section 3.3).

An alternative view is that the entire utility pole is a single asset – i.e. whatever portion of the pole the cable company's wire will hang from is not a physically distinct, identifiable asset. In addition to the fact that the portion of the utility pole used by the cable company is not physically or mechanically separated from the remainder of the pole (see Question 3.2.30), this view also considers the purpose of the utility pole to be relevant when evaluating its separability into physically distinct assets. That is, the pole is not physically or mechanically separated into distinct units because its primary purpose is not to serve as a multi-tenanted hosting device.

We believe either view is acceptable – i.e. that there is an identified asset or that there is not.

The view that the entire utility pole is the identified asset to be evaluated differentiates the utility pole from a multi-tenant office building, a cellular tower or a satellite with multiple transponders. At least partly, this is because the utility pole's primary use (or purpose) is to permit the utility company to provide its core service of supplying electricity; the utility's ability to generate economic benefit from the sale of excess pole space is secondary to its primary economic benefit. In contrast, for the multi-tenant office building, the cellular tower and the satellite, not only are the individual floors, rungs and transponders typically both physically and mechanically separable, but the larger asset has been constructed (or subsequently re-purposed) for the primary purpose of being subdivided and providing economic benefits from use to different parties simultaneously.

The analysis of the arrangements in the following chart follows the view that the primary use of the asset should inform the decision about the asset to evaluate under the lease definition. The following arrangements are examples; the principle illustrated may also apply to other arrangements.

Arrangement	Identified asset? <sup>1</sup>	Rationale
<b>Utility pole attachments</b>	No	See above discussion.
<b>Office (or retail) space in a multi-tenant building</b>	Yes	Consistent with the above discussion, the designated office or retail space is an identified asset if the supplier does not have a substantive substitution right (see section 3.2.3). If the customer controls its use (see section 3.3), there is a lease.

Arrangement	Identified asset? <sup>1</sup>	Rationale
<b>Use of a specific spot on a cell tower</b>	Yes	Consistent with the above discussion, the designated cellular tower space is an identified asset if the supplier does not have a substantive substitution right (see section 3.2.3). If the customer controls its use (see section 3.3), there is a lease.
<b>Satellite transponder</b>	Yes	Consistent with the above discussion, the designated transponder is an identified asset if the supplier does not have a substantive substitution right (see section 3.2.3). If the customer controls its use (see section 3.3), there is a lease.
<b>Use of space on the side of a building for advertising</b>	No	<p>The primary purpose of the side of the building is to enclose the interior of the building; the use of the outside of the wall to display advertising is secondary to the wall's primary purpose. This informs why the outside aspect (i.e. layer) of the wall, where the advertising will be displayed, is not physically or mechanically separable from the remainder of that wall, which is being used, primarily, to protect/support the building.</p> <p>Therefore, the space where the advertising is displayed is not an identified asset, and no lease exists because the advertising space customer is not obtaining substantially all of the economic benefits from use of the larger identified asset.</p> <p>Even though the space on the wall where the advertising is placed is not an identified asset, if the building owner attaches a frame or billboard to the building that is itself an item of property, plant or equipment, that frame or billboard can be leased (see item – 'Use of a billboard').</p>
<b>Use of space on the side of a bus stop shelter for advertising</b>	No	<p>The primary purpose of the side of the shelter is to enclose the space within it; the use of the outside of the shelter to display advertising is secondary to the shelter's primary purpose. This informs why the outside of the shelter wall, where the advertising will be displayed, is not physically or mechanically separable from the remainder of that wall, which is being used, primarily, to protect bus customers from the weather.</p> <p>Therefore, the space where the advertising is displayed is not an identified asset, and no lease exists because the advertising space customer is not obtaining substantially all of the economic benefits from use of the larger identified asset.</p> <p>Even though the space on the side of a bus stop shelter where the advertising is placed is not an identified asset, if the bus stop shelter owner attaches a frame or billboard to the bus stop</p>

Arrangement	Identified asset? <sup>1</sup>	Rationale
		shelter that is itself an item of property, plant or equipment, that frame or billboard can be leased (see next item – ‘Use of a billboard’).
<b>Use of a billboard</b>	Yes	The billboard is itself a capitalizable item of property, plant and equipment, and therefore it is an identifiable asset that can be leased. If an entity owns the billboard and grants a customer exclusive rights to use that billboard and the right to decide (and change) what advertising goes on the billboard during the period of use (even if subject to restrictions), the customer is leasing the identified billboard.
<b>Use of a building rooftop</b>	Yes	In most cases, we believe a rooftop is akin to the top floor of the building (albeit without a roof) – i.e. encompassing not <i>just</i> the surface of the roof, but the useful space above that surface where, for example, an entity may operate a rooftop bar or restaurant, or use as outdoor space for residential tenants. These uses are generally the primary use of that space. An entity may also primarily use that space to place valuable equipment (antennae, cellular towers, solar panels). Specific facts and circumstances will need to be considered when evaluating rooftop scenarios.

Note:

1. In general, regardless of the conclusion reached for each of the examples in this table, we believe it is acceptable to conclude that the item (i.e. the portion of the larger asset) is an identifiable asset. If the supplier does not have a substantive substitution right (see section 3.2.3), the asset will be identified. In that case, a lease exists if the customer controls its use (see section 3.3).



### Example 3.2.15

#### Rooftop space asset identification

*The following scenarios illustrate how to apply Question 3.2.40 to two scenarios in which a solar power producer obtains the right to use an unrelated third party’s rooftop space to place solar power generating equipment. These are not the only scenarios that exist. The conclusions reached in each of these scenarios are based on the totality of the facts and circumstances; no single fact or circumstance should be taken as individually determinative.*

#### Scenario 1: Rooftop supplier is solar power offtaker

Retailer operates retail stores across the US. To support those operations, it also owns a number of distribution centers, one of which is located in the Southwest (Southwest Distribution Center or the Center).

Retailer enters into a ‘Power Purchase Agreement’ (PPA) with Solar Supplier under which Solar Supplier will install, maintain and operate a solar power generating system at the Center from which Retailer will purchase all of the

electricity generated. The PPA includes a specific clause that permits Solar Supplier to install the solar system equipment on a portion of the Center's rooftop space and access that space as necessary to operate and maintain the equipment for the 15-year term of the PPA.

Assume that in appropriately applying Topic 842, Retailer and Solar Supplier each conclude that Retailer is *not* leasing the solar system equipment from Solar Supplier.

Next, each party evaluates whether Solar Supplier's right to use the Center rooftop space constitutes a lease of that space from Retailer to Solar Supplier (i.e. to permit Solar Supplier to provide its electricity supply service). In this evaluation, Retailer and Solar Supplier principally consider the following points.

- Retailer's primary business is its retail operations, and the Center is key thereto. Retailer is not in the business of acquiring and developing real estate properties for rental income or investment return.
- Retailer's primary use of the Center is to support retail operations, and the Center's roof is integral to protecting Retailer's equipment, inventory, distribution center personnel and continuity of distribution center operations.
- Retailer uses significant amounts of electricity to operate the Center; the PPA will (1) supply needed electricity, (2) further Retailer's carbon commitments and (3) comply with renewable energy usage regulations of the jurisdiction in which the distribution center resides.
- Retailer is purchasing all of the output generated by the solar system equipment; none of that output is being provided to other parties.

In this scenario, Retailer and Solar Supplier conclude there is *not* a lease of the rooftop space. Each concludes that the rooftop is *not*, in effect, a leasable space (i.e. akin to a second floor of the Center) on the basis that Retailer is not in the business of leasing or otherwise monetizing its real estate property. The primary purpose and function of the Center's roof is, as an integral component of the Center, to protect the Center's equipment, inventory, personnel and operations.

Consequently, each determines that it is reasonable to conclude that the rooftop space where the solar system equipment will be installed is not a separately identifiable asset under Topic 842 from the roof as a whole, the entirety of which is necessary to fulfill its defined primary purpose. Because Solar Supplier does not obtain substantially all of the economic benefits from use of the identified roof as a whole – i.e. Retailer obtains substantial economic benefits from the roof's fulfillment of its primary purpose – the roof is not being leased to Solar Supplier.

#### **Scenario 2: Rooftop supplier is a real estate owner and lessor not taking the solar power**

Real Estate Developer (RED) owns numerous office and industrial buildings. It owns those buildings as investment property and leases space therein to tenants for rental income.

RED enters into a 15-year 'Lease Agreement' with Solar Supplier that permits Solar Supplier to install, operate, monitor and maintain solar power generating

equipment on the rooftop of one of RED's buildings. RED will receive a fixed payment each year for these rights under the agreement. RED has no rights to require Solar Supplier to relocate the equipment during the 15-year agreement term.

The Lease Agreement refers to a power purchase agreement (PPA) between Solar Supplier and a third-party utility company unrelated to either RED or Solar Supplier. RED is not a party to this PPA. RED will take none of the electricity generated by the solar equipment installed on its building roof; the utility company will take and resell all of the electricity generated to its customers. RED's tenants in the building are not parties to the Lease Agreement or the PPA.

Because RED is taking none of the output from the solar equipment installed on its roof, RED is not leasing the solar system equipment from Solar Supplier (i.e. RED does not have the right to obtain substantially all of the equipment's economic benefits from use). Therefore, each party then evaluates whether Solar Supplier's right to use the building rooftop space to place Solar Supplier's solar system equipment constitutes a lease of that space from RED to Solar Supplier.

In making this evaluation, RED and Solar Supplier consider that RED's primary business is that of a real estate owner and lessor. As observable from its publicly available promotional, marketing and informational material, RED acquires investment property like the building in this arrangement for the primary purpose of earning a return on that property, inclusive of property appreciation and rental income over the time period it owns the property. RED earns rental income from all available sources at each of its properties, including interior and exterior space.

Because RED's primary use of the building is as a tenanted rental property, earning rental income from all leasable space, the rooftop space that will be occupied by Solar Supplier's equipment in this scenario *is*, in contrast to Scenario 1, a leasable space (i.e. akin to a top floor of the building and the interior space within the building). And because RED has no substitution rights, that space is an identified asset.

RED and Solar Supplier further conclude that Solar Supplier controls the use of the identified rooftop space throughout the period of use, and therefore that a lease exists, because:

- Solar Supplier has exclusive use of the identified rooftop space; that is, no other entity can place equipment or make substantive use of that space for economic benefit while Solar Supplier's equipment occupies it.
- Solar Supplier has the right to direct the use of the rooftop space. While all of the how and for what purpose decisions about the use of the space are effectively pre-determined by the agreement (i.e. that it will be used solely for the placement of Solar Supplier's solar system equipment), Solar Supplier is deemed to operate the space because it will solely install, maintain and (if necessary) replace the solar system equipment that will occupy the space.

Note that although RED is not an offtaker of the solar power generated by the solar system equipment installed on its roof in this scenario, the conclusion that

it is leasing the rooftop space on which the equipment is installed to Solar Supplier does not depend on that fact.



## Question 3.2.50 Right of first refusal

### Is a customer's right of first refusal over a portion of the capacity of an asset considered when assessing whether a capacity portion represents substantially all of the capacity of that asset?

**Interpretive response:** Yes, provided it is substantive. In some contracts, a supplier commits to making all of the capacity of an asset available to a customer, but may sell any unused capacity to third parties if the customer agrees. In these cases, the customer has the right to use substantially all of the capacity of the asset such that there is an identified asset.

For example, Customer enters into a 10-year contract with Supplier for specialized widgets. The supply contract does not specify the asset that will be used by Supplier to fulfill the contract, but Supplier's facility is implicitly specified because it is Supplier's only facility that is capable of manufacturing the specialized widgets, and it is specially designed for that purpose.

Customer's order is expected to consume approximately 70 percent of the capacity of the facility. Before Supplier is permitted to use the remaining capacity to produce specialized widgets for other customers, Supplier must notify Customer, and Customer has the right to take the remaining production capacity of the facility.

In this example, Customer is entitled to substantially all of the capacity of Supplier's manufacturing facility on the basis that it is contracted to use 70 percent of the capacity of the facility and has a right of first refusal for the other 30 percent. Therefore, and in consideration of the fact that the specially designed nature of the facility means it is not practicable for Supplier to substitute an alternative facility, the manufacturing facility is an identified asset.

**Note:** The right of first refusal would not be considered substantive if, to use the additional 30 percent of capacity, Customer was required to pay an incremental amount that was so high that it would be commercially unreasonable for Customer to purchase that additional capacity. In that case, Customer would not have the right to obtain substantially all of the capacity from the facility, and therefore there would not be an identified asset. Further, given Customer's substantive right to only 70 percent of the facility's capacity, the arrangement would also not contain a lease because Customer would not have the right to obtain substantially all of the economic benefits from its use (see section 3.3.3).

### 3.2.3 Does supplier have a substantive substitution right?



#### Excerpt from ASC 842-10

• • > Substantive Substitution Rights

**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:

- 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).
- 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:

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

**15-12** If the asset is located at the customer's premises or elsewhere, the costs associated with substitution are generally higher than when located at the supplier's premises and, therefore, are more likely to exceed the benefits associated with substituting the asset.

**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.

**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.

**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.

## 55 Implementation Guidance and Illustrations

### General

> Illustrations

• > Illustration of Identifying a Lease

• • > 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.

**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.

••> 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.

**55-54** Although the amount of space Customer uses is specified in the contract, there is no identified asset. Customer controls its owned kiosk. However, the contract is for space in the airport, and this space can change at the discretion of Supplier. Supplier has the substantive right to substitute the space Customer uses because:

- a. Supplier has the practical ability to change the space used by Customer throughout the period of use. There are many areas in the airport that meet the specifications for the space in the contract, and Supplier has the right to change the location of the space to other space that meets the specifications at any time without Customer's approval.
- b. Supplier would benefit economically from substituting the space. There would be minimal cost associated with changing the space used by Customer because the kiosk can be moved easily. Supplier benefits from substituting the space in the airport because substitution allows Supplier to make the most effective use of the space at boarding areas in the airport to meet changing circumstances.

••> 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.

**55-70** Customer has the right to control the use of Retail Unit A throughout the five-year period of use because:

- a. Customer has the right to obtain substantially all of the economic benefits from use of Retail Unit A over the five-year period of use. Customer has exclusive use of Retail Unit A throughout the period of use. Although a portion of the cash flows derived from sales from Retail Unit A will flow from Customer to Supplier, this represents consideration that Customer pays Supplier for the right to use the retail unit. It does not prevent Customer from having the right to obtain substantially all of the economic benefits from use of Retail Unit A.
- b. Customer has the right to direct the use of Retail Unit A. The contractual restrictions on the goods that can be sold from Retail Unit A and when Retail Unit A is open define the scope of Customer's right to use Retail Unit A. Within the scope of its right of use defined in the contract, Customer makes the relevant decisions about how and for what purpose Retail Unit A is used by being able to decide, for example, the mix of products that will be sold in the retail unit and the sale price for those products. Customer has the right to change these decisions during the five-year period of use.

**55-71** Although cleaning, security, and advertising services are essential to the efficient use of Retail Unit A, Supplier's decisions in this regard do not give it the right to direct how and for what purpose Retail Unit A is used. Consequently, Supplier does not control the use of Retail Unit A during the period of use, and Supplier's decisions do not affect Customer's control of the use of Retail Unit A.

3.2.80 Even if an asset is explicitly specified, there is no identified asset (and therefore the contract does not contain a lease) if the supplier has a substantive right to substitute the asset throughout the period of use. A substitution right is substantive when the supplier: [842-10-15-10]

- has the practical ability to substitute alternative assets throughout the period of use; and
- would benefit economically from the exercise of its substitution right – i.e. the economic benefits that will be derived from substituting the asset exceed the costs of the substitution; for example, costs to transport/relocate the original and the alternative asset, and associated labor costs.



### Observation

#### **Substantive substitution rights change the substance of the arrangement**

3.2.90 Evaluating whether a supplier substitution right is substantive is effectively a test to determine whether the supplier (rather than the customer) controls the use of the asset because it can substitute that asset throughout the period of use. When a substitution right is substantive, meaning that the supplier can substitute and redeploy that asset as it sees fit, the supplier has the right to decide how and for what purpose the asset is used, and therefore directs its use. A substantive substitution right changes the substance of the arrangement – i.e. there is not an identified asset. [\[IASU 2016-02.BC128–BC129\]](#)

3.2.100 The Board believes that it will be clear in many situations whether a substitution right is substantive. However, it may sometimes be difficult for a customer to make that determination. For example, a customer may not have sufficient information to perform the evaluation – e.g. assessing the supplier's costs and potential economic benefits from substituting the asset may be particularly difficult in many cases. This is why the Board included the presumption that substitution rights are not substantive when the customer cannot readily make that determination. Accordingly, a customer does not have to exert undue effort to prove that a substitution right is not substantive. [\[ASU 2016-02.BC130–BC132\]](#)

3.2.110 The specific guidance on substitution rights, especially the condition that the supplier must benefit economically from substituting the asset for a substitution right to be substantive (see paragraph 3.2.80), may mitigate structuring opportunities to include substitution clauses solely to avoid having an identified asset in the contract.

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3.2.120 In considering whether the supplier has the practical ability to substitute alternative assets, an entity considers whether the customer can prevent substitution and, if not, whether the supplier has ready access to an alternative asset or could source an alternative asset within a reasonable period. [\[842-10-15-10\(a\)\]](#)

3.2.130 An entity evaluates whether a supplier substitution right is substantive based on the facts and circumstances at inception of the contract. This evaluation excludes consideration of future events that, at inception, are not 'likely to occur'.<sup>1, 2</sup> For example: [\[842-10-15-11, 55-64\]](#)

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

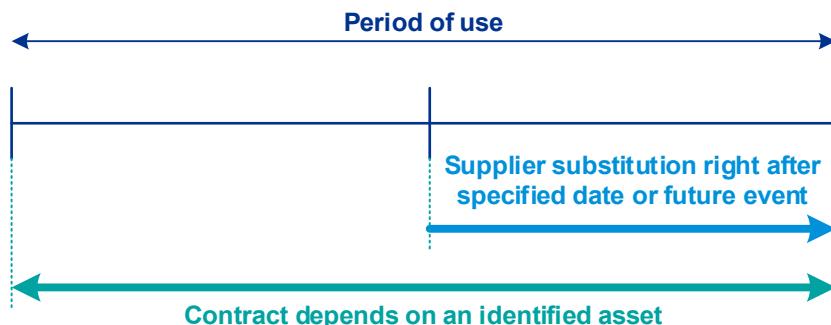
- the introduction of new technology not substantially developed at contract inception;
- a substantial difference between the customer's use of the asset, or the performance of the asset and the use or performance considered likely at inception of the contract; and/or
- a substantial difference between the market price of the asset during the period of use and the market price considered likely at inception of the contract.

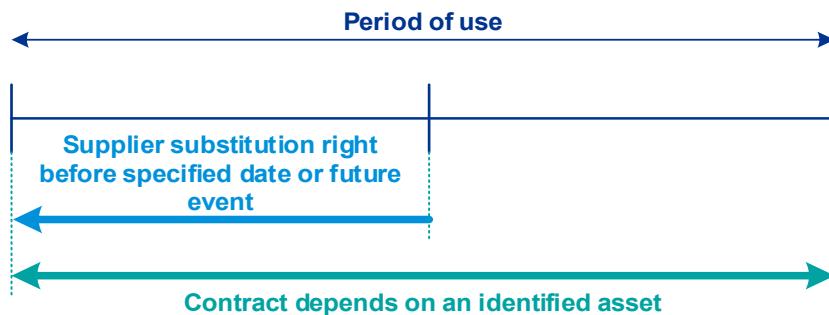
Notes:

1. Under US GAAP, 'probable' is defined as "the future event or events are likely to occur." Therefore, we believe 'likely to occur' is effectively the same threshold as 'probable'. [\[842 Glossary\]](#)
2. Example 4 in Subtopic 842-10 indicates that the Board views facts and circumstances that are "highly susceptible to factors outside of the supplier's influence" as not likely to occur. [\[842-10-55-63 – 55-71\]](#)

3.2.140 Topic 842 provides additional guidance to assist entities in determining whether a supplier substitution right is substantive, including the following.

- When the asset is located at the customer's premises (or somewhere other than the supplier's premises), the costs of substituting the asset are generally higher than when located at the supplier's premises. Accordingly, those costs are more likely to exceed the economic benefits of substitution. [\[842-10-15-12\]](#)
- When a supplier has a right or an obligation to substitute the asset only before, on or after (see diagrams below) either (1) a particular date within the period of use or (2) the occurrence of a specified event, the supplier does not have the practical ability to substitute alternative assets throughout the period of use. Therefore, the substitution right is not substantive. As a result, there is an identified asset for the entire period of use (see Question 3.1.30 on determining the period of use), unless or until the identified asset is substituted by the supplier. [\[842-10-15-13, ASU 2016-02.BC131\]](#)





- A supplier right or obligation to substitute the asset for repairs and maintenance, because the asset is not operating properly, or because a technical upgrade becomes available, does not preclude the customer from having the right to use an identified asset. [842-10-15-14]

3.2.150 If a customer cannot readily determine whether a supplier substitution right is substantive, it should presume that the substitution right is not substantive. [842-10-15-15, ASU 2016-02.BC132]

### Question 3.2.55

**Substitution rights that do not exist throughout the period of use**

#### Does a lease exist only for the portion(s) of the 'period of use' for which a substitution right does *not* exist?

**Background:** As illustrated in paragraph 3.2.140, a substitution right may not exist throughout the established 'period of use'; see Questions 3.1.30 and 3.1.40 about determining the period of use. For example, a substitution right may exist only:

- at the beginning of the period of use (front-loaded);
- at the end of the period of use (back-loaded); or
- during a discrete period(s) within the period of use.

A question arises as to whether, in those cases, a lease exists only for those periods of time for which the supplier does not have a substitution right. Specifically:

- In a 'front-loaded' substitution right scenario, does a lease exist only after the substitution right expires – i.e. the lease would commence on expiration of the substitution right?
- In a 'back-loaded' substitution right scenario, does a lease exist only for the period of time before the right becomes operative?
- In a discrete period(s) scenario, does a lease exist only during those periods for which a substitution right does not exist?

**Interpretive response:** No. We believe the guidance in Topic 842 and the basis for conclusions to ASU 2016-02 are explicit that a substitution right that does not exist 'throughout the period of use' is *not substantive*. In other words, a

substitution right that exists for only a portion of the period of use (whether front-loaded, back-loaded or for a discrete period (or periods) during the established period of use) is not substantive. And only a *substantive* substitution right affects lease identification. Therefore, based on the guidance described in paragraph 3.2.140, substitution rights that exist for only a portion of the period of use are effectively ignored when deciding whether or not a lease exists. [842-10-15-13, ASU 2016-02.BC128–BC129, BC131]

In addition, we do not believe a supplier's substitution rights affect (i.e. change) the period of use. For example, the period of use is not determined by the periods for which the supplier does *not* have a substantive substitution right. This is because, as explained in Question 3.1.30, the period of use is an *input* to the lease identification criteria in paragraph 3.1.40. It is therefore determined *before*, and *independent of*, the entity's evaluation of those criteria; it is not determined or affected by the evaluation of those criteria.

### Question 3.2.60

#### **Supplier's practical ability to substitute alternative assets**

#### **How does the guidance in paragraph 842-10-15-11 interact with the guidance in paragraph 842-10-15-13 when evaluating whether a supplier substitution right is substantive?**

**Interpretive response:** Paragraph 842-10-15-13 addresses whether a supplier has the practical ability to substitute alternative assets throughout the period of use. As discussed in paragraph 3.2.140, if the supplier has the right or obligation to substitute an alternative asset only on or after a specified date, or after the occurrence of a specified event, the substitution right is not substantive because it does not encompass the entire period of use. No consideration of the guidance in paragraph 842-10-15-11 is needed when a supplier substitution right does not encompass the entire period of use. [842-10-15-13]

Paragraph 842-10-15-11 applies when the supplier has the practical ability to substitute an alternative asset throughout the period of use and the entity (customer or supplier) is considering whether exercising that right will economically benefit the supplier. If a supplier with the practical ability to exercise a substitution right will only benefit economically from exercising that right under circumstances that are not 'likely to occur', that substitution right is not substantive. [842-10-15-11]

Consider the following contrasting scenarios.

- **A supplier leases a group of similar assets maintained at its premises to a customer.** The supplier has the right, throughout the period of use, to substitute the leased assets and has a pool of readily available alternative assets. Relevant experience demonstrates that (1) the supplier benefits economically from being able to deploy alternative assets as necessary to fulfill customer needs, and (2) the conditions that make substitution economically beneficial (e.g. the nature and mix of different customer

needs for the supplier's assets) are likely to continue throughout the period of use. In this scenario, the supplier's substitution right is substantive.

- **A supplier leases a piece of equipment to a customer.** The supplier has the right at any time throughout the period of use to substitute an alternative, but generally equivalent, piece of equipment and has readily available alternative assets. However, the supplier will only benefit economically from doing so if events and circumstances change from those at lease commencement; for example, a new customer wants to lease or buy the specific piece of equipment being leased and is willing to pay a premium to get it. The necessary circumstance in this case is not 'likely to occur' because it depends on factors substantially outside of the supplier's control and there is not relevant history to suggest this is likely to occur. In this scenario, the supplier's substitution right is *not* substantive.



### Question 3.2.70

**Substitution rights that are not economically beneficial throughout the period of use**

**Is a substitution right substantive if the supplier would not benefit economically from the exercise of its right throughout the period of use?**

**Background:** Consider the following scenario to illustrate the question. Customer enters into a 10-year contract with Supplier for the use of 50 similar assets that are new at lease commencement. Supplier has the contractual right and practical ability to substitute alternative assets, and is required to maintain the assets for no incremental consideration, throughout the 10-year period of use. Supplier expects to benefit economically from substituting used assets (which require more maintenance) with new ones and redeploying the used assets to a different class of customer. Given the economic life and expected degradation of the assets, Supplier is not expected to benefit economically from substituting any of these assets before the end of Year 3 but is expected to benefit economically after that time.

Paragraph 842-10-15-11 (see Question 3.2.60 for additional guidance relevant to this paragraph) states that, in the context of evaluating the substance of supplier substitution rights, future events should only be considered if 'likely to occur'. [842-10-15-11]

Meanwhile, paragraph 842-10-15-10 states that "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." [842-10-15-10]

Therefore, in the above scenario the question arises whether the supplier's substitution right is substantive given that it is likely that the supplier will be able to benefit economically from substitution, but not 'throughout the [10-year] period of use' – i.e. at least not for the first three years.

**Interpretive response:** We believe it depends, in general, on the significance of the portion of the period of use during which it is unlikely that events or circumstances will arise from which the supplier can benefit economically.

For example, in the background scenario, we believe Supplier's substitution right is not substantive because it is unlikely that events or circumstances will arise from which Supplier would benefit economically from substitution for three years of the 10-year period of use.

By contrast, consider Examples 1B and 2 (on railcars and airport concession space, respectively) in Subtopic 842-10 in which the supplier is determined to have a substantive substitution right. While not explicitly stated in either example, we believe those scenarios imply that it is unlikely events or circumstances would arise from which the supplier would benefit economically from substitution either: [842-10-55-42 – 55-54]

- immediately (or nearly immediately) after commencement (e.g. from moving an airport kiosk operator immediately after initially assigning them a terminal space); or
- for some period of time after substituting a terminal space or railcar; it appears some time would logically need to pass before changed events or circumstances would again make substitution economically beneficial to the supplier.

In addition, we believe it would generally be the case (i.e. in most scenarios) that near the end of the lease term, substitution would no longer be economically beneficial for a supplier; for example, if the supplier would soon after such substitution need to incur costs to retrieve the underlying asset at the end of the lease.

Based on the above altogether, and considering that the existence of paragraph 842-10-15-11 clearly indicates that the supplier does not have to be able to benefit economically from making a substitution "at all points in time" during the period of use for its substitution right to be substantive,<sup>1</sup> we believe a supplier substitution right is substantive only when the 'likely to occur' events and circumstances that would give rise to net economic benefits from substitution can feasibly arise at substantially any time during the period of use.

We believe a scenario meets this 'at substantially any time' test if the only time periods during which those events and circumstances are unlikely to arise during the period of use are (1) shortly after commencement, (2) shortly after a substitution occurs or (3) near the end of the lease term. By contrast, we believe any scenario, such as that in the background, in which there is a significant, identifiable portion of the period of use during which those events or circumstances are unlikely to occur does not.

Note:

1. An "at all points in time" interpretation of 'throughout the period of use' would effectively nullify paragraph 842-10-15-11; that is, if a supplier must benefit economically from substitution at all points in time during the period of use, then why would an entity need to consider whether future events are 'likely to occur'? [842-10-15-10(b), 15-11]



## Example 3.2.20

### Substitution rights

#### **Scenario 1: Supplier has substantive substitution right**

Customer enters into an arrangement with Supplier for a climate-controlled storage warehouse to store its coffee beans.

Supplier has the right to substitute the storage warehouse without Customer's consent throughout the term of the contract. The following additional facts are relevant.

- Supplier has many identical storage warehouses that are maintained in a single, accessible location and Supplier could easily substitute another storage warehouse for the one specified in the contract at a nominal cost.
- Supplier would benefit economically from substituting the storage warehouse because substitution allows it to make the most effective use of its storage warehouse portfolio to meet regularly changing circumstances, which are likely to continue throughout the period of use.

In this scenario, there is not an identified asset, because Supplier's substitution right is substantive. Accordingly, the contract does not contain a lease.

#### **Scenario 2: Supplier has substitution right that is not substantive – the underlying asset is significantly customized**

Changing the facts of Scenario 1, although Supplier has the right to substitute the storage warehouse without Customer's consent throughout the period of use, there are no other similarly customized warehouses in Supplier's portfolio or readily available from other suppliers.

In this scenario, the substitution right is not substantive because a similarly customized storage warehouse is not readily available – i.e. Supplier does not have the practical ability to substitute the storage warehouse.<sup>1</sup> Therefore, there is an identified asset. The next step is for the parties to determine whether Customer has the right to control the use of the warehouse (see section 3.3) to determine if there is a lease.

Note:

1. Even if Supplier could customize an alternative warehouse in its portfolio within a reasonable period of time, the cost of customizing and providing a similar alternative storage warehouse would likely exceed the economic benefits that would be realized from substitution – i.e. while Supplier would not obtain additional payments from Customer for the substitution, Supplier would incur potentially significant costs to customize an alternative warehouse to Customer's needs and to relocate Customer's inventory to the alternative warehouse. In that case, Supplier's substitution right would not be substantive because it would not benefit economically from the exercise of its substitution right.

#### **Scenario 3: Customer unable to determine whether supplier substitution right is substantive**

Changing the facts of Scenario 2, Customer is unable to determine whether the substitution right is substantive. In particular, Customer is unable to determine whether a similarly customized storage warehouse is readily available, or whether the economic benefits that would result from substitution exceed the expected costs of making the substitution. In this scenario, Customer does not

know whether Supplier has alternative warehouses or could source one in a reasonable period of time, and also does not know if Supplier would economically benefit from substituting the warehouse.

In this scenario, Customer presumes that the substitution right is not substantive, and therefore that there is an identified asset. The next step is for Customer to determine whether it has the right to control the use of the warehouse (see section 3.3) to determine if there is a lease.



### Example 3.2.30

#### **Supplier substitution right – evaluation of economic benefits**

Customer enters into a three-year lease of a multi-function copier/printer. The contract provides Customer with the right to determine how to use the machine during the three-year term (subject to the limitations of its design).

Supplier is required to provide an equivalent machine if the one originally delivered ceases to operate properly. Supplier may also substitute an equivalent machine at any time during the period of use at its expense and without Customer's approval.

Regarding Supplier's right of substitution, Supplier has other equivalent machines readily available. However, it is not likely that events or circumstances will arise from which Supplier would be able to generate more rental income by substituting an equivalent machine for the original machine than it would by leaving the original machine in place. Supplier would incur costs both to transport and install an equivalent machine at Customer's location, and to remove and transport the original machine to storage or to another customer's location.

In this example, Supplier's substitution right is not substantive, because the economic benefits from substituting the original machine for an alternate machine would not exceed the costs of the substitution. Therefore, there is an identified asset. The next step is for the parties to determine whether Customer has the right to control the use of the machine (see section 3.3) to determine if there is a lease.



### Example 3.2.40

#### **Assessing what is (are) the identified asset(s)**

##### **Scenario 1: Storage facility**

Storage Company owns a large storage facility that has 100 individual storage units of varying sizes and specifications – e.g. some are climate-controlled. Some customers desire second floor rather than first floor units, to protect against the potential for flooding.

Storage Company enters into a contract with Customer that permits Customer to select 10 storage units (that are not specified at contract inception) once it

determines its storage needs – e.g. Customer may decide that it wants some units to be adjoining to store complementary items, some units to be climate-controlled.

Those 10 units, once selected by Customer, will not comprise substantially all the storage capacity of the facility. In this Scenario, storage capacity is the only substantive economic benefit from use of the facility.

Just as if the storage units were selected at the time the contract was entered into, each unit, once it is selected by Customer, is an identified asset. Each of the 10 units is physically distinct and Storage Company cannot substitute that unit without Customer's permission – i.e. willingness to relocate to a different unit.

Customer controls the use of each unit because Customer:

- has the right to obtain substantially all of the economic benefits from use of each unit – i.e. Customer has exclusive use of the storage capacity of each unit; and
- directs its use – i.e. Customer generally decides, once selected, what and how much is stored in each unit.

Therefore, this contract contains 10 leases (one for each storage unit).

### **Scenario 2: Car fleet**

Car Company owns a fleet of more than 2,000 cars of different makes and models. Customer enters into a master lease agreement on January 1, 20X4 with Car Company for the right to use up to 50 cars until four years from the master lease agreement inception date. Customer will pay a monthly lease payment to Car Company for each car, once selected, based on the make and model.

Just as if cars were selected at the time the master lease agreement was entered into, each car, once it is selected by Customer, is an identified asset. Each of the 50 cars is physically distinct and Car Company cannot substitute that car for another car without Customer's permission. In any event, Car Company would be unlikely to benefit economically from doing so because the cars will be in Customer's possession (see paragraph 3.2.140).

Customer controls the use of each car because Customer:

- has the right to obtain substantially all of the economic benefits from use of each car – i.e. Customer has exclusive use of each car; and
- directs its use – i.e. Customer generally decides, once selected, where and when each car is used, and for what purpose.

Therefore, assuming Customer takes all 50 cars, this contract contains 50 leases (one for each car).

### **Scenario 3: Land plots that result in leases**

A landowner (Supplier) enters into an arrangement with a power company (Customer) for the right to select sites and construct 100 wind turbines on a 500-acre plot of land that is specified in the contract. Each wind turbine will occupy an area of 30 square yards to which Customer will have exclusive use rights.

Supplier retains the right to use the remainder of the 500-acre property – i.e. the portions of the property not encompassed by one of the 30 square yard plots. However, Supplier is not permitted to make use of the land within each 30 square yard plot – e.g. farm, allow cattle to graze, or construct a road across the land. This is the case regardless of whether Customer chooses to restrict access to those plots – e.g. by installing a fence around each one.

Supplier has no substitution rights – i.e. it cannot require Customer to relocate an installed wind turbine to another 30 square yard plot. The economic benefit associated with the use of the 100 30-square yard plots for the wind turbines does not represent substantially all of the economic benefits associated with the use of the entire 500-acre plot of land.

In this scenario, once selected, each 30 square yard plot of land is an identified asset, just as if the contract, at inception, had granted Customer the right to use 100 specifically identified plots. Each of the 100 plots represents implicitly-specified land that is physically distinct from any other of the 100 plots or from the remainder of the 500-acre property and Supplier has no substitution rights.

Customer controls the use of each 30 square yard plot because Customer:

- has the right to obtain substantially all of the economic benefits from use of each individual plot of land – i.e. it has exclusive use of each plot; neither Supplier nor any other party can use the land within each 30 square yard plot; and
- directs its use – i.e. the relevant how and for what purpose decisions are predetermined by the contract (Customer can only use the plots to install wind turbines), but Customer operates the plot within those predetermined rights of use because Customer will install and operate the wind turbines (see section 3.3.5).

Therefore, this contract contains 100 leases (one for each plot of land). If payments for the plots are made before the plots are selected, those payments are prepayments for the plot leases.

#### **Scenario 4: Land plots that do not necessarily result in leases**

Assume the same facts as Scenario 3, except that the contract does not restrict Supplier's ability to make use of the 500-acre plot of land – i.e. there are no plots of land around each of the 100 wind turbines that Supplier is not permitted to use.

There are no contractual, or otherwise enforceable, limitations on Supplier's right to access or make use of the land all the way up to where the bases of the turbines are installed in the ground. For example, Supplier's cattle are permitted to graze right up to the base of each wind turbine, which would include doing so underneath each turbine's blades.

The base of each wind turbine occupies a small, but clearly defined, place on the land – e.g. one foot x one foot.

One view is that the one square foot area occupied by the base of each wind turbine is an identified asset and that Customer has exclusive use of that land – i.e. has the right to obtain substantially all of the economic benefits from use of that land because there is no alternative use for that land once the wind turbine is installed. Consistent with Scenario 3, Customer also directs the use of each

plot where a turbine is installed by virtue of operating the wind turbine because all of the relevant decisions about how and for what purpose the plot will be used are predetermined – see section 3.3.5). Consequently, Supplier may conclude that the contract contains 100 leases – e.g. one for each 1 square foot plot of land.

An alternative view that we believe would be acceptable in these specific facts and circumstances is that the land occupied by the base of each wind turbine (e.g. each 1 square foot plot) is not physically distinct from the land surrounding the base under the turbine blades. This total land area is determined to be a single unit of account for lease evaluation because the land beneath the turbine blades is significantly restricted as to its available uses by virtue of being underneath the turbine blades – i.e. it cannot be used for any purpose that would interfere with the operation of the turbine. However, there are still substantive economic benefits that can be derived from using the remaining land (e.g. for farming or grazing cattle) and Supplier has the enforceable right to obtain those substantive, remaining economic benefits from use. Consequently, Customer does not have the right to obtain substantially all of the economic benefits from use of the identified unit of account – i.e. the land in which the turbine is installed and over which the turbine's blades operate – and no lease exists.



### Example 3.2.50 **Infrastructure-as-a-Service – identified assets**

Customer enters into a contract with Supplier to obtain specified network services that are provided through the use of 10 servers and various other networking equipment for five years. The network services provided by Supplier involve assets (servers and other equipment) located at Customer's premises.

The contract between Customer and Supplier requires Supplier to provide network services that meet a specified quality level, which if not met result in service-level penalties – i.e. credits against amounts owed by Customer to Supplier. Customer controls how and how much it uses the network services, but cannot (under the terms of the contract) change the configuration or specifications of the network (or 'turn off' the network).

The servers and the networking equipment to fulfill the network services are selected by Supplier, and then explicitly specified in the final contract. All of the specified equipment is dedicated to servicing Customer.

Supplier has the right to substitute the servers and other equipment at any time as long as the network services are not interrupted. However, because the servers and other equipment are located at Customer's premises, Supplier's substitution right is not substantive (see paragraph 3.2.140). That is, even though Supplier has alternative assets it could substitute (i.e. it has the practical ability to substitute alternative assets), it will not economically benefit from substituting the servers or equipment with other assets not presently dedicated to providing the network services to Customer. Accordingly, there are identified assets in the arrangement.

When evaluating whether a lease exists, consistent with the response to Question 3.2.10, each server and piece of equipment is an identified asset. Customer and Supplier do *not* evaluate the servers and other equipment as a combined unit of account (i.e. as a network).

Example 3.3.40 continues this example, determining whether Customer is leasing the identified servers and equipment.



### Example 3.2.60

#### Implicitly specified land asset with substitution rights

ABC Corp. enters into a contract with a State Department of Transportation (SDOT) to allow ABC to place its owned signs on the side of state highways. This is to advertise restaurants, hotels and gas stations located off of each highway exit.

SDOT decides where along each interstate the signs are to be placed and sets the parameters for what can be advertised. For example, SDOT only permits ABC to sell advertising space to food, lodging and fuel operators; ABC cannot sell space on its signs to any customers it chooses. SDOT also restricts the price ABC can charge for advertising space on its signs because SDOT wants food, lodging and fuel operator information to be available to state highway drivers.

SDOT has the contractual right to require ABC to relocate its signs.

- If SDOT requires the signs to be moved because of ABC's noncompliance with the terms and conditions of the contract, ABC is required to absorb the cost of moving the signs.
- However, if the signs are moved solely at the discretion of SDOT, the state will absorb the costs of moving the signs – i.e. SDOT will either move the signs itself or reimburse ABC for its costs incurred.

It is possible that SDOT might economically benefit from relocating one of ABC's signs – e.g. if the state approves a highway lane expansion or changes to a highway exit that will produce economic benefits for the state that exceed the costs of sign relocation. However, those circumstances are not 'likely to occur' at contract inception (see paragraph 3.2.130, Question 3.2.60 and Example 3.2.30).

In this example, even though the ultimate locations of ABC's signs are not, and will not be, specified in the contract between SDOT and ABC, there is an implicitly specified land asset for each plot of state-owned land on which ABC places one of its signs for advertising. Consistent with paragraph 3.2.20, fulfillment of the contract depends on SDOT providing land for ABC's placement of its signs and SDOT's right to substitute the land once ABC's signs are placed is not substantive – i.e. it is not likely SDOT will be able to benefit economically from its substitution rights.

For each implicitly specified plot of land, ABC has the right to obtain substantially all of its economic benefits from use. This is because each plot of

land will be exclusively used for the placement of ABC's sign. And while the relevant how and for what purpose decisions are predetermined by the contract (ABC can only use the plots to install signs), ABC operates the plot within those predetermined rights of use because ABC will install and operate the signs – i.e. by negotiating and selling advertising space on the signs to customers (see section 3.3.5). Therefore, ABC directs the use of each plot.

Consequently, the contract between ABC and SDOT contains leases of the implicitly specified plots of land on which ABC will install its signs.



## Comparison to legacy US GAAP

### **Identified asset concept aligns with Topic 840 guidance**

3.2.160 The concept of an identified asset is generally consistent with the concept of a specified asset under Topic 840. This includes the concept that an asset is implicitly identified if the supplier does not have a substantive substitution right. The Board decided not to revise this concept because it works well in practice. However, because concluding that a contract is or contains a lease has a more significant effect on customers' accounting compared to Topic 840, the Board also decided to provide additional guidance about when there is, or is not, an identified asset; in particular, providing significant additional guidance about how to evaluate whether a substitution right is substantive. [840-10-15-15]

### **Determining whether substitution rights are substantive**

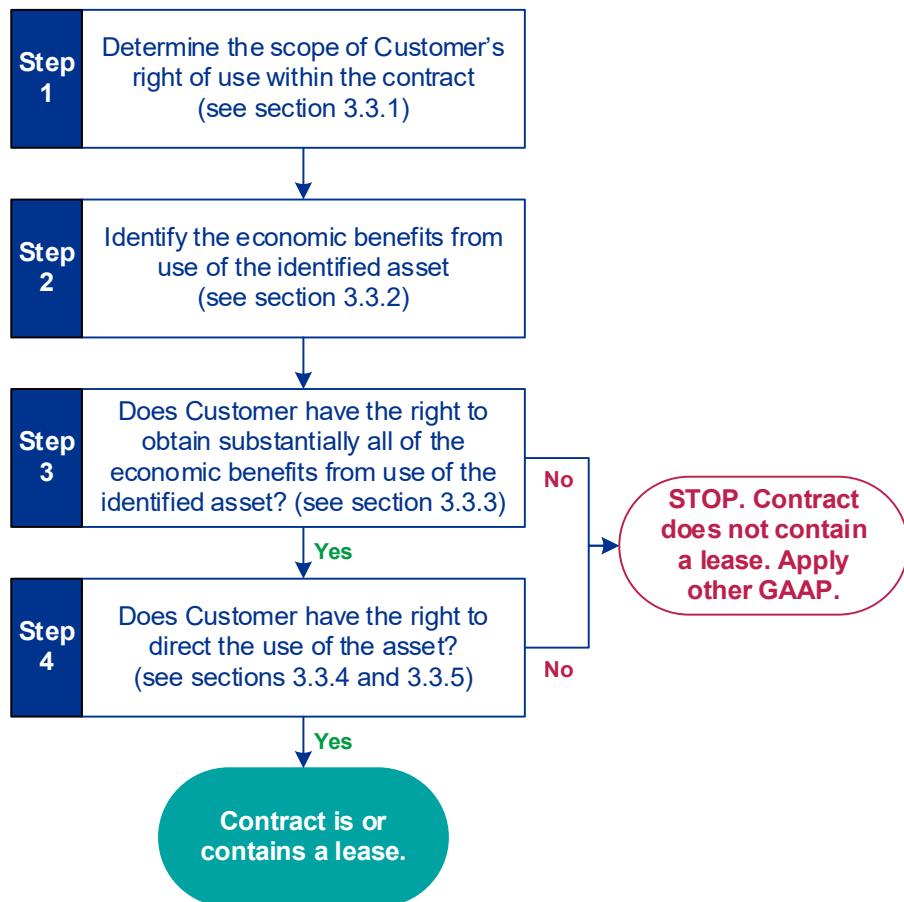
3.2.170 The explicit requirement that a substitution right must economically benefit the supplier – i.e. the economic benefits associated with substitution must exceed the corresponding costs – to be substantive is new to Topic 842. However, Topic 840 also provided that a contract depended on specified property, plant or equipment if it was not 'economically feasible' (i.e. it was 'uneconomical') to use an alternative asset. Therefore, applying the requirements in Topic 842 should not represent a substantial change from how Topic 840 should also have been applied. [840-10-15-5, 55-32(a), ASU 2016-02.BC129]

## 3.3 Does the customer control the use of the identified asset?

3.3.10 If an entity determines that a contract depends on the use of an identified asset (see section 3.2), it then evaluates whether the customer has the right to control the use of that asset for a period of time. This occurs when the customer has the right, throughout the period of use, to: [842-10-15-4]

- obtain substantially all of the economic benefits from the use of the identified asset; and
- direct the use of the identified asset.

3.3.20 Topic 842 introduces important concepts to determine whether a customer controls the use of an identified asset. The following flowchart depicts the decision process that an entity considers in this evaluation.  
[842-10-15-4, 15-20]



3.3.30 In many situations, this analysis will be straightforward and will require little to no judgment. However, for more complex situations, significant judgment may be needed.

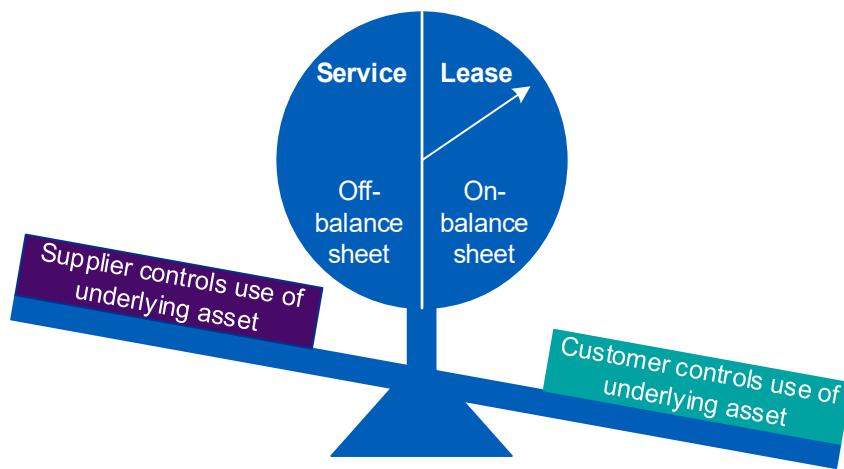


### Observation

#### A lease is different from a service

3.3.40 Who has control over the use of an asset is part of what differentiates a lease from a service. A lease exists when a customer has the right to make those decisions about the use of an asset that significantly affect the economic benefits to be derived from its use in a manner similar to the way in which an entity can make decisions about its owned property, plant and equipment. This concept of control, which is based on two elements (power over directing the use of the asset, and control of the economic benefits to be derived from use of the asset), is similar to how control is defined in Topic 606.

3.3.50 The Board observed that control of the use of the asset requires the customer to have decision-making rights over the use of the asset to influence the economic benefits derived from use of the asset – and this must be throughout the period of use. Without these rights, the Board concluded that the customer would have no more rights than if it were simply buying supplies or services, and the customer would not control the asset. This may be a change for certain arrangements that are currently accounted for as leases only because the customer obtains substantially all of the output (or other utility) from an asset. [ASU 2016-02.BC134]



### Question 3.3.10 Relevance of the control concept in Topic 810

#### Is the control concept in Topic 842 equivalent to the controlling financial interest concept in Topic 810?

**Interpretive response:** No. However, there are significant similarities between some aspects of the control concept in Topic 842 and the controlling financial interest concept in Topic 810. Both concepts comprise a power and a benefits characteristic. The power characteristic in Topic 810 is highly consistent with that in Topic 842, but the benefits characteristics are significantly different.

We believe one of the aspects of the power characteristic in Topic 810 that is particularly relevant to Topic 842 is when some, but not all, decisions that significantly affect economic performance are shared. Topic 810 requires one party to be identified as the party with power in these situations. We believe this is essentially the same approach that the Board decided to require in Topic 842 when some, but not all, of the relevant decisions that affect the economic benefits to be derived from use of the underlying asset are predetermined. [810-10-25-38E]

Under Topic 842, either the supplier or the customer is identified as the party with power in those circumstances – i.e. the guidance in paragraph 842-10-15-

20(b) on how to identify whether the customer has power when the relevant decisions about how and for what purpose an asset is used are predetermined does not apply. For further discussion about how to determine whether the customer has control when some or all of the how and for what purpose decisions are predetermined, see sections 3.3.4 and 3.3.5, respectively.

### 3.3.1 Step 1: What is the scope of the customer's right of use within the contract?



#### Excerpt from ASC 842-10

- • > Right to Obtain the Economic Benefits from the Use of the Identified Asset

**15-18** When assessing the right to obtain substantially all of the economic benefits from use of an asset, an entity shall consider the economic benefits that result from use of the asset within the defined scope of a customer's right to use the asset in the contract (see paragraph 842-10-15-23). For example:

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

- • > Right to Direct the Use of the Identified Asset

- • • > Protective Rights

**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.

#### 55 Implementation Guidance and Illustrations

##### General

- > Illustrations

- > Illustration of Identifying a Lease

• • > 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.

**55-70** Customer has the right to control the use of Retail Unit A throughout the five-year period of use because:

- a. Customer has the right to obtain substantially all of the economic benefits from use of Retail Unit A over the five-year period of use. Customer has exclusive use of Retail Unit A throughout the period of use. Although a portion of the cash flows derived from sales from Retail Unit A will flow from Customer to Supplier, this represents consideration that Customer pays Supplier for the right to use the retail unit. It does not prevent Customer from having the right to obtain substantially all of the economic benefits from use of Retail Unit A.
- b. Customer has the right to direct the use of Retail Unit A. The contractual restrictions on the goods that can be sold from Retail Unit A and when

Retail Unit A is open define the scope of Customer's right to use Retail Unit A. Within the scope of its right of use defined in the contract, Customer makes the relevant decisions about how and for what purpose Retail Unit A is used by being able to decide, for example, the mix of products that will be sold in the retail unit and the sale price for those products. Customer has the right to change these decisions during the five-year period of use.

**55-71** Although cleaning, security, and advertising services are essential to the efficient use of Retail Unit A, Supplier's decisions in this regard do not give it the right to direct how and for what purpose Retail Unit A is used. Consequently, Supplier does not control the use of Retail Unit A during the period of use, and Supplier's decisions do not affect Customer's control of the use of Retail Unit A.

•• > Example 6—Ship

••• > Case B—Contract Contains a Lease

**55-85** Customer enters into a contract with Supplier for the use of a specified ship for a five-year period. The ship is explicitly specified in the contract, and Supplier does not have substitution rights.

**55-86** Customer decides what cargo will be transported and whether, when, and to which ports the ship will sail, throughout the five-year period of use, subject to restrictions specified in the contract. Those restrictions prevent Customer from sailing the ship into waters at a high risk of piracy or carrying hazardous materials as cargo.

**55-87** Supplier operates and maintains the ship and is responsible for the safe passage of the cargo onboard the ship. Customer is prohibited from hiring another operator for the ship or operating the ship itself during the term of the contract.

**55-88** The contract contains a lease. Customer has the right to use the ship for five years.

**55-89** There is an identified asset. The ship is explicitly specified in the contract, and Supplier does not have the right to substitute that specified ship.

**55-90** Customer has the right to control the use of the ship throughout the five-year period of use because:

- a. Customer has the right to obtain substantially all of the economic benefits from use of the ship over the five-year period of use. Customer has exclusive use of the ship throughout the period of use.
- b. Customer has the right to direct the use of the ship. The contractual restrictions about where the ship can sail and the cargo to be transported by the ship define the scope of Customer's right to use the ship. They are protective rights that protect Supplier's investment in the ship and Supplier's personnel. Within the scope of its right of use, Customer makes the relevant decisions about how and for what purpose the ship is used throughout the five-year period of use because it decides whether, where, and when the ship sails, as well as the cargo it will transport. Customer has the right to change these decisions throughout the five-year period of use.

**55-91** Although the operation and maintenance of the ship are essential to its efficient use, Supplier's decisions in this regard do not give it the right to direct how and for what purpose the ship is used. Instead, Supplier's decisions are dependent on Customer's decisions about how and for what purpose the ship is used.

• • > Example 7—Aircraft

**55-92** Customer enters into a contract with an aircraft owner (Supplier) for the use of an explicitly specified aircraft for a two-year period. The contract details the interior and exterior specifications for the aircraft.

**55-93** There are contractual and legal restrictions in the contract on where the aircraft can fly. Subject to those restrictions, Customer determines where and when the aircraft will fly and which passengers and cargo will be transported on the aircraft.

**55-94** Supplier is responsible for operating the aircraft, using its own crew. Customer is prohibited from hiring another operator for the aircraft or operating the aircraft itself during the term of the contract.

**55-95** Supplier is permitted to substitute the aircraft at any time during the two-year period and must substitute the aircraft if it is not working. Any substitute aircraft must meet the interior and exterior specifications in the contract. There are significant costs involved in outfitting an aircraft in Supplier's fleet to meet Customer's specifications.

**55-96** The contract contains a lease. Customer has the right to use the aircraft for two years.

**55-97** There is an identified asset. The aircraft is explicitly specified in the contract, and although Supplier can substitute the aircraft, its substitution right is not substantive. Supplier's substitution right is not substantive because of the significant costs involved in outfitting another aircraft to meet the specifications required by the contract such that Supplier is not expected to benefit economically from substituting the aircraft.

**55-98** Customer has the right to control the use of the aircraft throughout the two-year period of use because:

- a. Customer has the right to obtain substantially all of the economic benefits from use of the aircraft over the two-year period of use. Customer has exclusive use of the aircraft throughout the period of use.
- b. Customer has the right to direct the use of the aircraft. The restrictions on where the aircraft can fly define the scope of Customer's right to use the aircraft. Within the scope of its right of use, Customer makes the relevant decisions about how and for what purpose the aircraft is used throughout the two-year period of use because it decides whether, where, and when the aircraft travels as well as the passengers and cargo it will transport. Customer has the right to change these decisions throughout the two-year period of use.

**55-99** Although the operation of the aircraft is essential to its efficient use, Supplier's decisions in this regard do not give it the right to direct how and for what purpose the aircraft is used. Consequently, Supplier does not control the use of the aircraft during the period of use, and Supplier's decisions do not affect Customer's control of the use of the aircraft.

3.3.60 A lease may not grant a customer an unlimited or unrestricted right to use an asset. For example, a contract may limit the customer's use of a motor vehicle or an aircraft to only one particular territory, or up to a particular number of miles, during the period of use. These limits or restrictions define the scope of the customer's right to use the identified asset. While limits or restrictions of this nature affect what economic benefits can be derived from use of the asset during the period of use, a lease still exists if: [842-10-15-4, 15-18]

- the customer has the right to obtain substantially all of those economic benefits; and
- substantive relevant decision-making rights about the use of the asset that the customer controls (e.g. when and where the motor vehicle or aircraft travels within the unrestricted territory) remain unrestricted.

3.3.70 A contract may include terms and conditions designed to protect the supplier. Protective rights are provisions in the contract that, for example, are intended to: [842-10-15-23]

- protect the supplier's interest in the underlying asset (e.g. by preventing a customer from transporting particular types of goods, such as explosives) or other of its owned assets (e.g. a larger asset of which the identified asset is a physically distinct portion);
- protect its personnel (e.g. restrictions preventing the customer from sailing a ship in high risk waters when the supplier's personnel operate the asset); or
- ensure the supplier complies with laws and regulations (e.g. legal restrictions on where an aircraft can fly).

3.3.80 The Board concluded that protective rights generally define the scope of the rights a customer obtains rather than affecting the existence of a right to use an asset. Contractual restrictions of this nature are known and agreed to by the customer and are an inherent part of the contract pricing – i.e. the contractual consideration reflects the economic substance of the right of use. [ASU 2016-02.BC141]

3.3.90 Example 4, Example 6 Case B, and Example 7 in Subtopic 842-10 each illustrate scenarios where a lease is determined to exist even though there are substantive restrictions about how and for what purpose the lessee may use the identified asset. [842-10-55-63 – 55-71, 55-85 – 55-99]



### Question 3.3.20

#### Contractual restrictions affecting whether or not there is a lease

**Can contractual restrictions limiting the scope of a customer's rights to use an underlying asset be so restrictive that a lease does not exist?**

**Background:** Topic 842 describes rights to specify the maximum amount of use of an asset or where or when the customer can use the asset as supplier protective rights; however, it also describes similar rights as examples of

decision-making rights that grant the customer the right to direct how and for what purpose the underlying asset is used. Accordingly, at various points during the Board's project, some suggested that an entity would need to evaluate whether restrictions in a contract are merely protective in nature or whether they are so restrictive that they preclude the customer from controlling the use of the underlying asset. [842-10-15-23, 15-25]

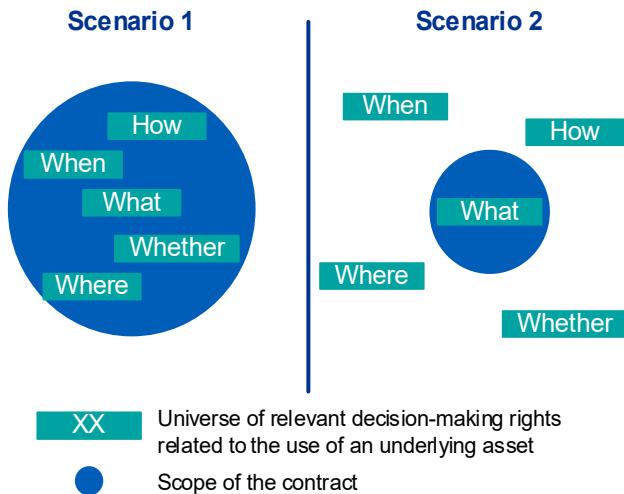
**Interpretive response:** Yes. However, we expect such circumstances to be rare. It is possible that in an extreme circumstance, the restrictions imposed on the customer could be so restrictive that they leave the customer with no substantive decision-making authority over the use of the asset. In that case, there is no lease.

In general, we believe contractual restrictions define the scope of the customer's right to use the underlying asset, and that restrictions on the use of the asset agreed to by the customer and the supplier reflect just another form of predetermined decision. Therefore, in the vast majority of arrangements, including those with significant contractual restrictions, the customer has the right to direct the use of the asset if there are substantive decisions about the use of the asset that are still available to be made and the customer controls those available decisions that will most significantly affect the economic benefits to be derived from use of the asset during the period of use (see sections 3.3.4 and 3.3.5).

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3.3.100 The following scenarios illustrate the principle of looking only at the rights that are within the scope of the contract. [842-10-15-18, 15-24 – 15-25]

- In Scenario 1, none of the possible, relevant decision-making rights in relation to the underlying asset are predetermined – e.g. by restrictions in the contract or the design of the asset. Therefore, in assessing whether the customer controls the use of the asset, all of these rights are considered; this does not mean, however, that the customer must have all of those decision-making rights for there to be a lease (see section 3.3.4).
- In Scenario 2, the customer's decision-making rights in the contract encompass only what the underlying asset can be used for – i.e. what output the asset can produce. Therefore, in assessing whether the customer controls the use of the asset, only these rights are considered. This scenario assumes that the 'what' decisions are substantive and significantly affect the economic benefits that can be derived from the use of the asset.



### 3.3.2 Step 2: What are the economic benefits from use of the identified asset?



#### Excerpt from ASC 842-10

• • > Right to Obtain the Economic Benefits from the Use of the Identified Asset

**15-17** To control the use of an identified asset, a customer is required to have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use (for example, by having exclusive use of the asset throughout that period). A customer can obtain economic benefits from use of an asset directly or indirectly in many ways, such as by using, holding, or subleasing the asset. The economic benefits from use of an asset include its primary output and by-products (including potential cash flows derived from these items) and other economic benefits from using the asset that could be realized from a commercial transaction with a third party.

3.3.110 Once the scope of a customer's right to use an asset is determined (see section 3.3.1), an entity should only consider, when determining whether the customer has the right to control the use of the identified asset, the economic benefits arising from the use of that asset. Topic 842 explains that this includes direct benefits (e.g. from using, holding or subleasing the asset) and other economic benefits related to the use of the asset (e.g. renewable energy credits received, or byproducts arising from the use of an asset) that could be realized in a commercial (arm's length) transaction. [842-10-15-17, ASU 2016-02-BC135]



### Question 3.3.30

#### Evaluating the substance of economic benefits from use

##### Do the economic benefits from use of an identified asset include those that are unlikely to accrue?

**Interpretive response:** No. When determining the economic benefits from use of an identified asset, an entity should not consider economic benefits that are unlikely to be realized; such rights are not substantive.

For example, assume a landowner grants an entity the right to use its land located in the desert (e.g. to construct a solar plant), but the contract permits the landowner to farm the land surrounding the plant. In this scenario, if the desert land is not arable, the farming rights are not substantive and are not considered when determining whether the customer has the right to obtain substantially all of the economic benefits from use of the land throughout the period of use.



### Question 3.3.39

#### Analyzing economic benefits from use of an asset

##### What are the economic benefits that can be derived from the use of an asset?

**Background:** Topic 842 does not provide significant guidance on what does and does not constitute an economic benefit from use. Further, how to apply the term 'economic benefits from use' – e.g. whether to apply that term broadly or narrowly – was not a significant topic of public discussion by the FASB and the IASB during the development of Topic 842. The lack of guidance in Topic 842, or public discussion by the Boards, around this topic is giving rise to a number of questions in practice. [842-10-15-17, ASU 2016-02.BC135]

Improper identification of the economic benefits from use of an identified asset may result in an improper conclusion about whether the customer has the right to obtain substantially all of the economic benefits from use of the asset over the period of use (see Question 3.3.80), and therefore potentially about whether a lease exists.

**Interpretive response:** In general, we believe the most relevant consideration in deciding whether an economic benefit is an economic benefit *from use* may be whether operation of the asset is necessary to generate the benefit and, if so, whether decisions about how much the asset is operated significantly affect the amount of benefit generated. If not, it is likely that the economic benefit in question is *not* an economic benefit from use of the asset.

The following are two examples and our analysis. Further examples are included in Questions 3.3.42 and 3.3.45.

### **Brand/image benefits stemming from the supplier's logo being displayed in a prominent location on the asset in a public location**

In general, we do not believe that the perceived brand/image (or advertising) benefit resulting from an asset having the supplier's brand or logo displayed on it is an economic benefit *from use*.

This is because the branding that is displayed on the asset is a characteristic of the asset's appearance, rather than a characteristic of its functionality.

Characteristics of functionality are what give rise to the potential economic benefits that an asset can produce from its use. Conversely, the appearance of an asset does not affect the potential economic benefits that the asset can produce from being used because those potential benefits generally accrue regardless of when, whether or how much the asset is used. Those benefits may also more aptly be described as benefits from ownership, rather than from use, if the supplier's branding is a result of the asset's design that cannot be changed and is unaffected by who the customer is or their use of the asset.

Therefore, any perceived brand/image (or advertising) benefit resulting from an asset's appearance (including the branding imagery displayed on the asset) should be excluded from the analysis of the economic benefits generated from the asset's use.

### **Cash flows from the sale of consumables used in operating or used to 'stock' the asset**

Cash flows may be derived from the sale of consumables used in operating the asset (e.g. ink toner used in a photocopier), or from the sale of products used as inventory of the asset (e.g. candy in a vending machine).

In some cases, payment to the supplier for the purchased consumables is not contingent on those consumables being used or on them being 'sold through' to an end-customer. For example, the supplier may be entitled to the transaction price for the consumables regardless of whether the customer uses the ink toner or whether the candy in the vending machine is ever purchased by an end customer. In such cases, we believe the economic benefits to the supplier from the sale of those consumables derive from the transfer of the consumables to the customer, and do not derive from the use of the machine; therefore, those economic benefits are not considered when assessing the economic benefits from use of the machine.

In other cases, payment to the supplier is due only on use or sell-through of the consumables – e.g. the supplier gets a percentage of the selling price of candy sold from the vending machine. In any of these cases, the economic benefits realized from use of the machine (i.e. the outputs produced, such as photocopied pages from the photocopier, or the cash flows from sale of the candy from the vending machine) are economic benefits from use. However, we believe those economic benefits from use accrue to the *customer*, rather than the supplier. The payments to the supplier for the consumables are not economic benefits from use, but rather payments for the right to use the machine and/or the consumables (see paragraphs 3.3.150 – 3.3.160).



### Question 3.3.40

#### Total economic benefits from use of an asset

##### Is the capacity of an asset to produce outputs the only economic benefit that can be derived from use of the asset?

**Interpretive response:** No. Example 3.3.10 considers the facility's capacity to produce airbags as the only substantive means to derive economic benefits from use of the facility. However, a facility's capacity to produce output may not be the only means by which to derive economic benefits from its use. For example, the economic benefits that an entity can derive from a renewable energy power plant include more than the electricity produced if the plant's power production also gives rise to renewable energy credits.

Another example might be a production facility such as that in Example 3.3.10, but where the steam from the manufacturing process is sold as a by-product to a power generation company (third party unrelated to the customer). In that case, the economic benefits to be derived from the facility include those related to the facility's capacity to produce airbags and those that can be realized from the facility's production of steam as a by-product.



### Question 3.3.42

#### Data about customer's use of the asset

##### Is data collected from a customer's use of an identified asset an economic benefit from use that affects lease identification?

**Background:** A vendor may supply an asset to a customer and then gather data from or about the customer's use of the asset that the vendor can use internally or sell to a third party. For example, a vehicle manufacturer provides a customer with the use of a vehicle that includes smart-driving technology, which collects data about how or where the vehicle is operated and communicates that data back to the manufacturer. That data may then be used by the manufacturer (e.g. to update its mapping software) and/or monetized by the manufacturer through sales to third parties.

**Interpretive response:** It depends. We believe an entity first should consider the asset's role in, for example, collecting, organizing or transmitting the data to other parties. In general, if the functionality of the underlying asset (i.e. its use) is essential to deriving economic benefit from the data – i.e. the data is an output of utilizing that functionality, the economic benefits to be derived from use of the underlying asset may include those that can be realized from the sale or use of the data.

In contrast, if the underlying asset has no functional role in, for example, collecting, organizing or transmitting the usage data, we believe economic benefits derived from the sale or use of the data are not economic benefits from use of the underlying asset. Rather, as an example, they may be economic

benefits of ownership if the asset owner obtains and/or has rights to the data by virtue of its ownership of the underlying asset. Economic benefits derived from ownership, rather than from use, of the underlying asset are not considered in deciding whether a lease exists. [IASU 2016-02.BC135]

The following are examples.

Fact pattern	Analysis
<p>A <b>vehicle manufacturer</b> provides a customer with the use of a vehicle that includes smart-driving technology, which collects data about how/where the vehicle is operated and communicates that data back to the manufacturer. This data may include information about the frequency and time of use, speed, distance and/or the roadways on which the vehicle travels. That data is then used by the manufacturer (e.g. to update its mapping software) and/or monetized by the manufacturer through sales to third parties.</p>	<p>If the software that is an integral component of the vehicle is responsible for the collection of vehicle use and mapping data and for communicating that back to the manufacturer, the economic benefits derived from the data collected and transmitted back to the vehicle manufacturer by the functionality of the vehicle's software would likely be considered economic benefits from use of the vehicle (see <i>Customer ownership of data</i>).</p>
<p>A <b>telecommunications company</b> provides customers with the use of various customer premise equipment (CPE). For example, In the residential space, CPE may include television set-top boxes, internet modems and routers. As a result of providing its services, the company obtains data about its customers, such as their viewing habits, that it can sell to third parties or use for its own economic benefit – e.g. in deciding when and where to place advertisements or in marketing advertising slots to its customers.</p>	<p>The analysis of this example is generally consistent with that for the vehicle manufacturer. If the CPE is responsible for the collection of the relevant customer data and communicating that back to the telecommunications provider, the economic benefits derived from the data collected and transmitted by the functionality of the applicable CPE would likely be considered economic benefits from use of the applicable CPE (see <i>Customer ownership of data</i>).</p>
<p>A <b>shopping mall owner</b> has data about its customers' sales because the customers' payments to the shopping mall owner are based on a percentage of the stores' sales. That data may be used by the owner in pricing and advertising the space or similar spaces</p>	<p>The customer sales data obtained by the shopping mall owner is not collected, organized or communicated to the shopping mall owner by the rented retail space. Rather, the data is obtained as a result of the shopping mall owner's right to receive lease payments as the owner of the underlying asset. Therefore, any economic benefits the shopping mall owner can derive from use of that data are economic benefits resulting from the mall owner's <i>ownership</i>, rather than from use, of the underlying asset</p>

### Customer ownership of data

If the customer legally owns and must grant permission for the vehicle manufacturer to either obtain or make use of the data (e.g. due to customer privacy laws), we believe the customer's action of releasing the data for the supplier's use is effectively an additional, noncash payment to the manufacturer of a portion of the economic benefits from use of the asset. It is similar in nature to making a payment of a portion of the cash flows derived from use of the asset to the asset supplier (see paragraphs 3.3.150 – 3.3.160).

In that case, the benefits of the data would not be allocated to the supplier (e.g. the vehicle manufacturer or the telecommunications provider in the background examples), but rather to the customer, when deciding whether the customer has the right to obtain substantially all the economic benefits from use of the identified asset.



### Question 3.3.45

#### Supplier use of the identified asset

**Are economic benefits from use of an identified asset that accrue to the supplier factored into determining whether the customer has the right to obtain substantially all the economic benefits from use of the asset?**

**Background:** An asset may be able to serve multiple entities (e.g. multiple customers) at the same time (see Example 3.3.20). And some assets are able to perform multiple functions, and therefore serve multiple entities because of those multiple functionalities, simultaneously. The following are examples.

- As described in Question 3.3.40, a manufacturing facility may produce both products and steam (as a by-product). Different customers may benefit from the facility's production of each – i.e. the manufacturer may sell the products to one customer and the steam to another. Alternatively, the manufacturer may be able to use the steam itself – e.g. to power another adjacent facility it operates – such that it does not need to obtain electricity from a third party to power that facility.
- A piece of equipment may simultaneously permit a customer to connect to a supplier's database or network *and* provide data to the supplier about the database or network's operating performance, and/or serve as a gateway for the supplier to perform troubleshooting of its network. And the equipment may be capable of performing these functions for the supplier both when the customer is actively using it, and when the customer is not using it – e.g. as long as the equipment remains switched on or connected to a power source and connected to the supplier's network. The equipment's functionality permitting the supplier to monitor and troubleshoot its broader network may mean that the supplier does not have to use other equipment or personnel to perform those functions, or it may permit the supplier to perform those functions with fewer personnel or alternative, less expensive resources.

In scenarios such as these, there is a question about whether the economic benefits the supplier has the right to obtain from the use of the asset should factor into the 'economic benefits from use' test – i.e. whether the customer has the right to obtain substantially all the economic benefits from the use of the asset over the period of use.

**Interpretive response:** In general, an identified asset providing economic benefits from its use to both the supplier and the customer is no different from the asset providing economic benefits from its use to multiple customers (see Example 3.3.20).

If, as described in the background, outputs from use of the asset provide utility to both the supplier and the customer (i.e. the identified asset serves as a tool to both the supplier and the customer) the economic benefits the supplier derives from that utility should be factored into the economic benefits from use test. This is regardless of whether those economic benefits are realized through:

- monetization of the outputs in a transaction with a third party – e.g. sale of the steam in the manufacturing facility background example to an unrelated manufacturer or power producer; or
- through the use of the outputs by the supplier itself – e.g. use of the steam in the manufacturing facility example to power the manufacturer's adjacent facility or use of the inherent functionality of the equipment in the telecommunications example to monitor or troubleshoot its network.

### Quantifying supplier or other non-customer rights to economic benefits from use

Topic 842 requires that the customer have the right to obtain 'substantially all', not *all*, of the economic benefits from use of the identified asset over the period of use (see Questions 3.3.60 and 3.3.80). Therefore, an asset providing economic benefits from its use to the supplier (or another entity) as well as the customer, does not mean a lease cannot exist (if the other lease identification criteria are met). Rather, for a lease not to exist based on the 'economic benefits from use' test, entities (including the supplier) other than the customer must have the right to obtain a more-than-insignificant portion of the economic benefits from use of the asset over the course of the 'period of use'.

When there are shared economic benefits from use, it may be necessary to quantify both (1) the total potential economic benefits from use of the identified asset over the course of the period of use and (2) the portion of the economic benefits from use to which each entity – i.e. the customer and the supplier or the customer and another entity – has rights over that period of time. In some cases, there may be significant judgment and/or complexity involved in performing the evaluation.



## Question 3.3.50

**Tax attributes**

**Do the economic benefits that can be derived from use of the asset include tax attributes?**

**Interpretive response:** No. The Board reasoned that a lease conveys a right to use the underlying asset; it does not convey ownership. Accordingly, benefits derived from ownership of the asset (e.g. income tax credits) are excluded from the evaluation. [ASU 2016-02.BC135]

While certain tax credits may be indirectly related to the underlying asset's use (e.g. production tax credits), we believe all benefits related to tax attributes should be excluded from the population of economic benefits to be considered in determining whether there is a lease.



## Observation

**Government priorities can drive whether there is a lease**

3.3.120 Governments establish and change incentives or subsidies, such as renewable energy credits, for reasons that may often be unrelated to the value of the output produced by an asset. These governmentally established incentives or subsidies are not a result of the underlying asset's utility and are artificial – i.e. because they can be established, revoked or changed by government at any time.

3.3.130 Therefore, we believe that over time, equivalent arrangements granting a customer the right to use an asset could meet or not meet the definition of a lease based solely on government priorities (e.g. whether government is currently trying to encourage one activity or another) at contract inception.

**3.3.3**

**Step 3: Does the customer have the right to obtain substantially all of the economic benefits from use of the identified asset?**

**Excerpt from ASC 842-10**

- • > Right to Obtain the Economic Benefits from the Use of the Identified Asset

**15-17** To control the use of an identified asset, a customer is required to have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use (for example, by having exclusive use of the asset throughout that period). A customer can obtain economic benefits from

use of an asset directly or indirectly in many ways, such as by using, holding, or subleasing the asset. The economic benefits from use of an asset include its primary output and by-products (including potential cash flows derived from these items) and other economic benefits from using the asset that could be realized from a commercial transaction with a third party.

**15-19** If a contract requires a customer to pay the supplier or another party a portion of the cash flows derived from use of an asset as consideration, those cash flows paid as consideration shall be considered to be part of the economic benefits that the customer obtains from use of the asset. For example, if a customer is required to pay the supplier a percentage of sales from use of retail space as consideration for that use, that requirement does not prevent the customer from having the right to obtain substantially all of the economic benefits from use of the retail space. That is because the cash flows arising from those sales are considered to be economic benefits that the customer obtains from use of the retail space, a portion of which it then pays to the supplier as consideration for the right to use that space.

## 55 Implementation Guidance and Illustrations

### General

- > Illustrations
  - > Illustration of Identifying a Lease
  - • > Example 8—Contract for Shirts

**55-100** Customer enters into a contract with a manufacturer (Supplier) to purchase a particular type, quality, and quantity of shirts for a three-year period. The type, quality, and quantity of shirts are specified in the contract.

**55-101** Supplier has only one factory that can meet the needs of Customer. Supplier is unable to supply the shirts from another factory or source the shirts from a third-party supplier. The capacity of the factory exceeds the output for which Customer has contracted (that is, Customer has not contracted for substantially all of the capacity of the factory).

**55-102** Supplier makes all decisions about the operations of the factory, including the production level at which to run the factory and which customer contracts to fulfill with the output of the factory that is not used to fulfill Customer's contract.

**55-103** The contract does not contain a lease.

**55-104** The factory is an identified asset. The factory is implicitly specified because Supplier can fulfill the contract only through the use of this asset.

**55-105** However, Customer does not control the use of the factory because it does not have the right to obtain substantially all of the economic benefits from use of the factory. This is because Supplier could decide to use the factory to fulfill other customer contracts during the period of use.

**55-106** Customer also does not control the use of the factory because it does not have the right to direct the use of the factory. Customer does not have the right to direct how and for what purpose the factory is used during the three-year period of use. Customer's rights are limited to specifying output from the factory in the contract with Supplier. Customer has the same rights

regarding the use of the factory as other customers purchasing shirts from the factory. Supplier has the right to direct the use of the factory because Supplier can decide how and for what purpose the factory is used (that is, Supplier has the right to decide the production level at which to run the factory and which customer contracts to fulfill with the output produced).

**55-107** Either the fact that Customer does not have the right to obtain substantially all of the economic benefits from use of the factory or the fact that Customer does not have the right to direct the use of the factory would be sufficient in isolation to conclude that Customer does not control the use of the factory.

3.3.140 Evaluating whether a customer has the right to obtain substantially all of the economic benefits from use of an asset throughout the period of use will be straightforward in many situations, generally because the customer in a lease frequently has exclusive use of the asset. However, in some situations, a contract may provide a party other than the customer the right to more than a minor amount of the economic benefits from use of the same asset.



### Question 3.3.60 **Meaning of 'substantially all'**

**What does 'substantially all' mean in the context of whether the customer has the right to obtain substantially all of the economic benefits from use of the identified asset?**

**Interpretive response:** The Board did not define what 'substantially all' means in the context of the definition of a lease. However, Topic 842 uses the same terminology in one of the criteria used to determine lease classification: whether the present value of the sum of the lease payments and residual value guaranteed by the lessee equals or exceeds substantially all of the fair value of the asset (see section 6.2). In that case, Subtopic 842-10 includes implementation guidance that states that one acceptable approach to assessing that criterion is to conclude that 90 percent or more of the fair value of the underlying asset amounts to substantially all the fair value of the underlying asset. [842-10-55-2(c)]

In addition, 'substantially all' is used elsewhere in US GAAP and is usually interpreted to mean 90 percent. As a result, we believe an entity should generally use 90 percent as its benchmark in evaluating whether the customer has the right to obtain substantially all of the economic benefits from use of an asset.



### Example 3.3.10

#### **Right to obtain the economic benefits from use – outsourcing arrangement**

##### **Scenario 1: Supplier can use the factory to supply other customers**

Customer enters into a 10-year agreement with Supplier to purchase a particular type and quantity of airbags. The following facts are relevant.

- Supplier has only one factory that can meet the needs of Customer.
- Supplier is unable to supply the airbags from another factory and does not have the right or ability to source the airbags from a third-party supplier.
- The capacity of the factory significantly exceeds the output for which Customer has contracted, and the factory is used to fulfill contracts with a number of Supplier's customers.
- There are no substantive economic benefits that can be derived from use of the facility other than those that are derived from its production of airbags.

In this scenario, Customer does not control the use of the factory because it does not have the right to obtain substantially all of the economic benefits from use of the factory. This is because Supplier can obtain more than an insignificant portion of the economic benefits from use of the factory by producing parts and selling them to other customers. Therefore, the arrangement is not a lease of the factory that will produce the airbags.

##### **Scenario 2: Supplier cannot use the factory to supply other customers**

Changing the facts of Scenario 1, Supplier designed and constructed the factory that will produce the airbags specifically to meet Customer's demand. The factory is specified in the contract and Supplier does not have the practical ability to source the airbags from another factory. The factory's capacity to produce airbags is the only way in which the factory can produce economic benefits from its use.

The existing capacity of the factory will be used to produce only the particular type and quantity of airbags requested by Customer, and Customer has the right to purchase all of the airbags produced by the facility – i.e. Supplier cannot use the factory to supply other customers. Supplier has the right to expand the facility in the future if it wishes to, and therefore expand its capacity; however, at contract inception it is not likely that it will do so.

In this example, Customer has the right to obtain substantially all of the economic benefits from use of the factory. Supplier's right to expand the facility, at which point the facility would be able to generate additional economic benefits from use that Customer might not control, is not considered in arriving at this conclusion. This is because an expanded facility would be a different asset from the one identified in the contract. Therefore, the arrangement is a lease if Customer also has the right to direct the use of the factory throughout the period of use (see section 3.3.4 and Example 3.3.60).

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3.3.150 A contract may require a customer to pay a portion of the cash flows derived from the use of an asset to the supplier (or another party) as

consideration; this does not prevent the customer from obtaining substantially all of the economic benefits from use of that asset. For example, a customer may be required to pay the supplier a percentage of sales as consideration for use of retail space. The cash flows from those sales are considered economic benefits that the customer receives, a portion of which it then pays to the supplier as consideration for the right to use the retail space. [842-10-15-19]



### Observation

#### Payment of portion of cash flows from an asset to the supplier (or another party)

3.3.160 We believe the Board's intent with the provision outlined in paragraph 3.3.150 was to establish that the customer obtaining the economic benefits from use of the asset (e.g. the cash flows obtained from selling products in a leased retail store) generally is separate from its payment of a portion of those cash flows to the supplier as additional rent. Variable payments of this nature should not affect the identification of a lease any differently from fixed payments that are often made with cash flows generated from use of the asset. Fixed or variable payments may be significant compared to the economic benefits generated by use of the asset (e.g. in high-rent locations), and we believe the Board intended that the amount of the payments for the right to use the asset (even if significant as compared to the economic benefits to be derived from the use of that asset) generally should not affect the conclusion about whether a lease exists.



### Question 3.3.70

#### Fixed economic return from use of an identified asset

**Does an entity have the right to obtain substantially all the economic benefits from use of an identified asset if the economic benefits it retains are fixed while the asset owner's are variable?**

**Background:** An entity may obtain a fixed rate of return from the use of an asset, while the asset owner (or another party) receives/absorbs all of the variability in net operating profits. For example, a hotel or casino operation may permit an entity to operate the property, but pay that entity a fixed fee for those operations, while the property owner (or another party, such as an investor) receives the net operating profits of the hotel or casino operation.

**Interpretive response:** Not necessarily. An entity (i.e. the potential lessee) may not have the right to obtain substantially all the economic benefits from use of an identified asset if it obtains a fixed rate of return and the asset owner (or another party) receives/absorbs all of the variability in net operating profits, particularly if the owner also receives most of the economic benefits from use of the asset; for example, most of the cash flows from the use of the asset, such as from a casino or hotel operation. In that situation, we believe careful

consideration should be given to the substance of the contract, including the nature of the arrangement between the parties, when determining whether the entity has the right to obtain substantially all of the economic benefits from use of the identified asset; for example, whether the nature of the arrangement is that the entity is in effect an agent (or service provider) of the asset owner rather than the principal in the operation that is using the asset.

In general, we do not believe paragraph 842-10-15-19 was intended to capture situations where the potential lessee receives only a fixed return on the use of the identified asset or has only minimal exposure/upside from the use of the asset. In such cases, we generally believe the entity does not have the right to obtain substantially all of the economic benefits from use of the asset, and therefore there is not a lease.

Further, if the entity is receiving only a fixed, or substantially fixed, return on the use of the asset, and the asset owner retains all (or substantially all) of the risks/rewards from the use of the asset, the owner will typically also have the right to direct the use of the asset – i.e. control the most important decisions about how and for what purpose the asset is used (see section 3.3.4). If the owner is subject to the significant economic variability from use of the asset, while it may outsource operational aspects of the asset's use, it is unlikely to forfeit rights to key decisions about, for example, when and whether the asset operates that most significantly affect the economic benefits that can be derived from the asset's use.

However, because facts and circumstances can vary widely, careful consideration should be given to the substance of the contract, including the nature of the arrangement between the parties – e.g. whether the customer is in effect an agent of the supplier rather than the principal in the operation that is using the asset – when determining whether the customer has the right to control the use of the asset in a contract of this nature.



### Question 3.3.80

#### **Changes to the customer's right to obtain the economic benefits from use during the period of use**

**If the customer does not have the right to obtain substantially all of the economic benefits from use of an identified asset for a portion of the period of use, can there be a lease?**

**Background:** In Example 3.3.10, Customer entered into a 10-year agreement with Supplier to purchase a particular type and quantity of airbags. That example considered the facility's capacity to produce airbags as the only substantive means to derive economic benefits from use of the facility (see Question 3.3.40).

Continuing that example, assume instead that the economic benefits to be derived from use of the facility include not just the facility's capacity to produce airbags, but also the facility's production of steam as a manufacturing by-product. In addition, under a pre-existing contract, Supplier will sell all of the

facility's steam production to a third party unrelated to Customer for the first three years of the contract with Customer. After those three years, Customer will have the exclusive right to the steam produced by the facility.

The steam constitutes a more than insignificant (15%) portion of the total economic benefits available from use of the facility in a given year, and the remainder (85%) is associated with the facility's production of airbags. As such, in Years 1–3 and in Years 4–10, the portion of the total economic benefits from use to which Customer has rights is 85% and 100%, respectively.

**Interpretive response:** Yes. In the background example, when evaluating whether Customer has the right to obtain substantially all of the economic benefits from use of the facility throughout the 10-year period of use, we believe 'throughout the period of use' means 'over the course of the period of use'. Accordingly, because Customer has the right to approximately 96% of the total economic benefits expected from use of the facility over the total 10-year period of use, Customer has the right to obtain substantially all of the economic benefits from use of the facility throughout the period of use, and the contract will meet the definition of a lease with a 10-year lease term if Customer also has the right to direct the use of the asset (see sections 3.3.4 and 3.3.5). This is generally consistent with how entities evaluated under Topic 840 whether it was remote that one or more parties other than the customer would take more than a minor amount of the output or other utility that would be produced or generated by the property, plant or equipment during the term of the arrangement. [840-10-15-6(c)]

We do not believe an entity should define the period of use to exclude those periods during the contract term during which the customer does not have the right to obtain substantially all of the economic benefits from use of the asset. In the background example, doing so would result in a 7-year period of use, and consequently a 7-year lease (i.e. a lease that exists in Years 4–10 only) if Customer has the right to direct the use of the asset throughout that 7-year period. Consistent with our responses to Questions 3.1.30 and 3.2.55, we believe this would inappropriately treat the evaluation of the 'right to obtain substantially all the economic benefits from use' lease identification criterion as an input to determining the period of use rather than treating the period of use as an input to determining whether the customer 'has the right to obtain substantially all of the economic benefits from use of the asset *throughout the period of use*' (emphasis added).

### Question 3.3.90 Time-based land easements

#### Does a time-based land easement meet the definition of a lease?

**Background:** See Questions 2.3.10, 3.1.10 and 3.2.20 for additional discussion about land easements. As discussed in Question 2.3.10, land easements are in the scope of Topic 842. Question 3.1.10 highlights that a perpetual land

easement does not meet the definition of a lease, and Question 3.2.20 discusses considerations for roving (or floating) easements.

**Interpretive response:** We believe the analysis of whether a lease exists differs depending on whether the easement grants the right to use surface or subsurface (i.e. underground) land.

### Surface land rights

If an easement grants a lessee rights to use surface land, that land is the unit of account for evaluating whether a lease exists. This is regardless of whether another entity has rights to use the subsurface land (e.g. to bury a telecommunications cable or a pipeline).

Therefore, if the grantee has exclusive rights to use the identified surface land, we believe a land easement will typically meet the definition of a lease. If the grantee has the exclusive right to the substantive uses of the land (see Question 3.3.30) subject to the easement, the grantee will also typically have the right to direct the use of the asset because either:

- the grantee has the right to direct how and for what purpose the land to which it has exclusive use rights is used; or
- if those rights are predetermined (e.g. the easement specifies how the land must be used, such as solely for the construction of a pipeline or the laying of telecommunications cable or conduit), the grantee will operate the land from the perspective of undertaking the predetermined activity.

In contrast, if the easement grants only nonexclusive rights to use the identified surface land (see Example 3.2.40, Scenario 4), a lease does not exist.

### Subsurface land rights

Many land easements give the grantee only rights to use land that is underground. For example, an easement may permit the grantee to construct an underground pipeline or bury telecommunications cable or conduit, but also permit the grantor or another party rights to use the land surface – e.g. to farm on the land or to install a cellular tower.

For subsurface land easements of this nature, there are presently mixed views about whether a lease exists. In the absence of further guidance from the FASB or the SEC staff, we will accept either view, applied consistently.

#### ***View 1: Subsurface land is identifiable and can be leased***

Under this view, the land should be subdivided by surface rights and subsurface rights, which may be further subdivided into multiple subsurface rights by depth.

In applying this view, the grantee may have exclusive rights to the substantive uses of an identified subsurface portion of the land even if other entities (or the grantor) have rights to use other identified surface or subsurface portions of the land. For example, the grantee has exclusive rights to bury a telecom cable between a depth of 10–20 feet below the surface at a specified latitude and longitude, while the grantor has the right to farm the surface of the land and a third party has the right to bury an underground pipeline at a depth of more than 20 feet below the surface. For the same reasons as for surface land rights, if

the grantee has exclusive use of that identified subsurface land, the easement would typically meet the definition of a lease.

### **View 2: Rights to use subsurface land akin to air rights**

This view equates subsurface land easements such as those described in the example under View 1 – i.e. in general, where the subsurface land subject to the easement is not inhabited or generally accessible – to air-use rights.

Air-use rights are explicitly identified in US GAAP as an example of a contract-based *intangible* asset; therefore, such rights (or a lease of such rights) are outside the scope of Topic 842. Consequently, under this view, because these subsurface land easements are considered to be substantially equivalent to air-use rights, they are also considered to be outside the scope of Topic 842.  
 [805-20-55-37, 842-10-15-1(a)]

Importantly, this view does not equate all subsurface land easements to air-use rights. For example, rights to use underground land for a retail or other similar store (e.g. in a subway station), which will be used in a manner consistent with surface land, are not analogous to air-use rights.

### **Contract grants both surface and subsurface land rights**

A contract that grants explicit rights to use both the surface of the identified land and defined subsurface space may include two units of account.

An entity that applies View 1 for the subsurface land rights would conclude that there are two units of account: the surface land rights and the subsurface land rights. This is unless the effect of separate accounting is insignificant (see section 4.1.2) – e.g. because the rights are co-terminus and each lease would be classified as an operating lease if classified separately.

An entity that applies View 2 for the subsurface land rights would conclude that there are two units of account: a separate lease component for the rights to use the surface land, and a non-lease component for the right to use the subsurface land. This is unless the entity elects (and, if a lessor, meets the criteria to apply) the practical expedient not to separate lease and non-lease components (see section 4.4.1).

We do not believe an entity should *infer* that subsurface rights exist in a contract that explicitly grants surface land use rights only, unless subsurface rights are explicitly granted. In other words, it would be inappropriate for an entity to assign a portion of its fixed payments for the surface land lease to an implicit subsurface rights component.



### **Example 3.3.20** **Internet service agreement**

Customer enters into a contract with a telecommunications company (Supplier) for high-speed internet access. Supplier delivers the high-speed internet access via an internet router that is specified in the contract by serial number. The internet router contains two antennae: one antenna broadcasts wireless internet via a secure signal to Customer (i.e. Customer can secure with a password so no one else can access the signal), while the other

antenna broadcasts internet to any other devices or other high-speed internet customers.

The internet service contract includes an identified asset, the internet router (which is specified in the contract), and Supplier would not economically benefit from substituting a similar asset. However, Customer does not have exclusive use of the output from the router. Therefore, unless the economic benefits that can be derived from use of the second antenna are insignificant in relation to the economic benefits that can be derived from use of the router overall, there is not a lease because Customer does not have the right to obtain substantially all of the economic benefits from use of the router.

### 3.3.4 Step 4: Does the customer have the right to direct the use of the asset?



#### Excerpt from ASC 842-10

- > Right to Direct the Use of the Identified Asset

**15-20** A customer has the right to direct the use of an identified asset throughout the period of use in either of the following situations:

- a. The customer has the right to direct how and for what purpose the asset is used throughout the period of use (as described in paragraphs 842-10-15-24 through 15-26).
- b. The relevant decisions about how and for what purpose the asset is used are predetermined (see paragraph 842-10-15-21) and at least one of the following conditions exists:
  1. The customer has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use without the supplier having the right to change those operating instructions.
  2. The customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

**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.

**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.

••• > How and for What Purpose an Asset Is Used

**15-24** A customer has the right to direct how and for what purpose an asset is used throughout the period of use if, within the scope of its right of use defined in the contract, it can change how and for what purpose the asset is used throughout that period. In making this assessment, an entity considers the decision-making rights that are most relevant to changing how and for what purpose an asset is used throughout the period of use. Decision-making rights are relevant when they affect the economic benefits to be derived from use. The decision-making rights that are most relevant are likely to be different for different contracts, depending on the nature of the asset and the terms and conditions of the contract.

**15-25** Examples of decision-making rights that, depending on the circumstances, grant the right to direct how and for what purpose an asset is used, within the defined scope of the customer's right of use, include the following:

- a. The right to change the type of output that is produced by the asset (for example, deciding whether to use a shipping container to transport goods or for storage, or deciding on the mix of products sold from a retail unit)
- b. The right to change when the output is produced (for example, deciding when an item of machinery or a power plant will be used)
- c. The right to change where the output is produced (for example, deciding on the destination of a truck or a ship or deciding where a piece of equipment is used or deployed)
- d. The right to change whether the output is produced and the quantity of that output (for example, deciding whether to produce energy from a power plant and how much energy to produce from that power plant).

**15-26** Examples of decision-making rights that do not grant the right to direct how and for what purpose an asset is used include rights that are limited to operating or maintaining the asset. Although rights such as those to operate or maintain an asset often are essential to the efficient use of an asset, they are not rights to direct how and for what purpose the asset is used and often are dependent on the decisions about how and for what purpose the asset is used. Such rights (that is, to operate or maintain the asset) can be held by the customer or the supplier. The supplier often holds those rights to protect its investment in the asset. However, rights to operate an asset may grant the customer the right to direct the use of the asset if the relevant decisions about how and for what purpose the asset is used are predetermined (see paragraph 842-10-15-20(b)(1)).

**55 Implementation Guidance and Illustrations****General**

- > Illustrations
  - > Illustration of Identifying a Lease
    - • > Example 9—Contract for Energy/Power
      - • • > 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.

• • > 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.

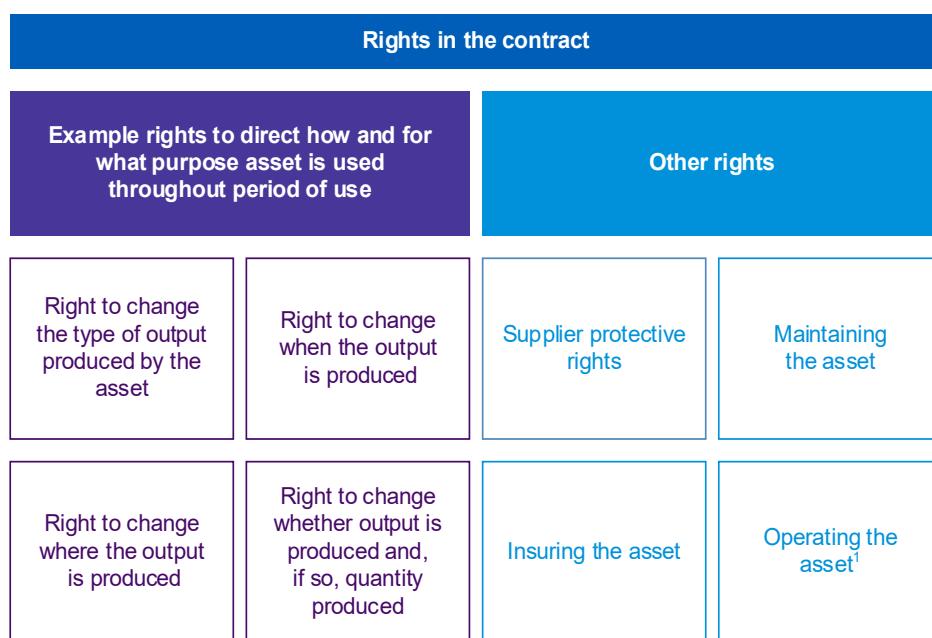
3.3.170 This section looks at the general considerations relevant in determining whether the customer or the supplier has the right to direct the use of the asset throughout the period of use, while section 3.3.5 looks more closely at situations in which the substantive decision making about how and for what purpose the asset will be used is predetermined.

3.3.180 A customer has the right to direct the use of an identified asset when it has control over those decision-making rights about the use of the asset that are most relevant to (i.e. those that most significantly affect) the economic benefits that can be derived from the asset's use. Conversely, the supplier has

the right to direct the use of the identified asset if it controls those decision-making rights. The decisions that are most relevant will vary by contract.

3.3.190 Decisions about how and for what purpose the asset is used during the period of use are most relevant to the economic benefits that can be derived from the asset's use. Therefore, a customer has the right to direct the use of an identified asset when it has the right to direct (and change) how and for what purpose the asset is used throughout the period of use; for example, the ability to decide how leased space in a retail unit is used, or where and when a leased ship sails and what cargo it transports because those 'relevant decisions' are those that most significantly affect the economic benefits to be derived from use of the asset. [842-10-15-20, 15-24]

3.3.200 Topic 842 provides examples of decision-making rights that do and do not grant an entity the right to direct how and for what purpose an identified asset is used (in the scope of its right of use). [842-10-15-25 – 15-26]



Note:

- Decisions about when or whether to operate the asset may be relevant 'how and for what purpose' decisions (see Question 3.3.100). In addition, a customer's right to make other operational decisions affects whether the customer has the right to direct the use of the asset if all of the relevant how and for what purpose decisions are predetermined (see section 3.3.5).

3.3.210 A contract may include provisions that are intended to protect the supplier's interest in the asset or other assets, protect its personnel, or comply with laws or regulations – 'supplier protective rights' in the chart in paragraph 3.3.200. [842-10-15-23]

3.3.220 Such rights typically define the scope of the customer's right to use the asset but do not, in isolation, prevent the customer from having the right to direct the use of the asset (see paragraph 3.3.60). [IASU 2016-02.BC141]



## Observation

**'Relevant decisions' affect how and for what purpose an asset is used**

3.3.230 The basis for conclusions to ASU 2016-02 explains that 'relevant decisions' about the use of an asset are those that affect what and how much economic benefit is derived from the asset's use. The Board concluded that decisions about how and for what purpose an asset is used are more important in determining who has control over the use of an asset than other decision-making rights (such as maintenance or operational decisions) that depend on, and typically subordinate to, the decisions about how and for what purpose an asset is used. [\[ASU 2016-02.BC137\]](#)



## Question 3.3.100

### Operational decisions

**Can decisions about the operation of an asset be relevant 'how and for what purpose' decisions about the use of the identified asset?**

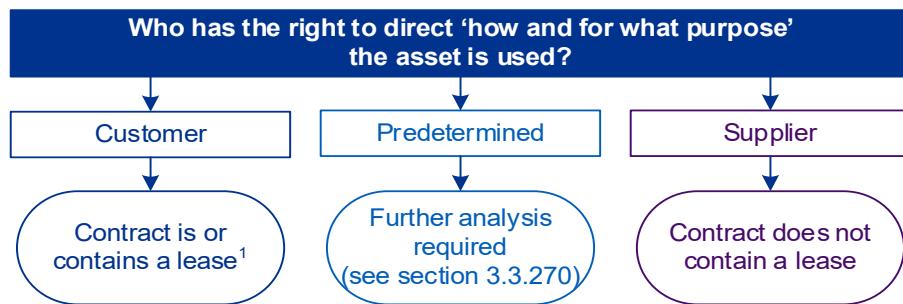
**Interpretive response:** It depends on what is considered an 'operational decision', which is not defined in Topic 842.

Based on the discussion in paragraph 842-10-15-26 and paragraph BC137 in the basis for conclusions to ASU 2016-02, we believe the Board considered operational decisions to be limited to those that affect the efficiency of an entity's use of the asset – e.g. the route the ship takes, the angle at which the drilling rig undertakes drilling or the driving of the truck; but do not affect what, when, whether or how much the asset is operated. That is, operational decisions are decisions subject to, and do not include, broader decisions about what, when, whether or how much the asset is operated.

However, if whether or when to operate the asset (e.g. when or whether to turn a piece of equipment on or off) is considered an operational decision, then those decisions about whether or when to operate the asset are, in accordance with paragraph 842-10-15-25, relevant decisions that affect the economic benefits that will be derived from use of the asset. Those decisions would therefore be considered along with other relevant decisions about how and for what purpose the asset will be used that are available to be made during the period of use – e.g. decisions about *what* output the asset will produce – when determining who has the right to direct the use of the identified asset.

Other decisions about operating the asset that do not affect what, when, whether or how much the asset is operated are not relevant decisions (unless all of the relevant how and for what purpose decisions are predetermined – see section 3.3.5).

3.3.240 The customer or the supplier may have the right to direct how and for what purpose the identified asset is used. In other cases, the relevant decisions about how and for what purpose the asset is used may be predetermined – e.g. through restrictions or other provisions in the contract. [842-10-15-20, 55-1]

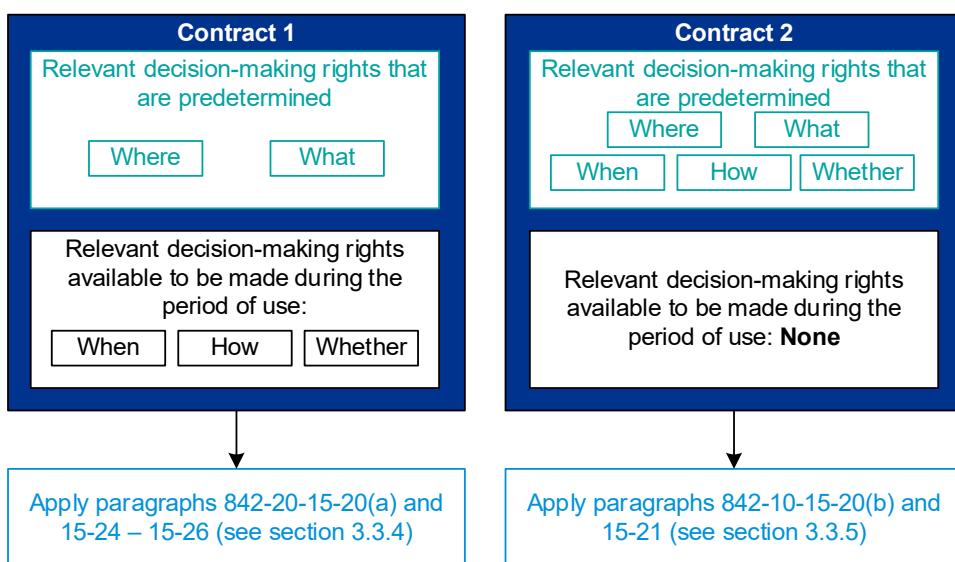


Note:

1. If other criteria are met (see sections 3.2 and 3.3.3).

3.3.250 An entity should only consider which party (i.e. the customer or the supplier) has the right to make decisions about the use of the asset during the period of use – i.e. in evaluating whether a lease exists or not, an entity ignores decisions that are predetermined in the contract – unless the customer designed the asset or specific aspects thereof (see section 3.3.5). [842-10-15-22]

3.3.260 When all of the relevant decisions about how and for what purpose the asset will be used throughout the period of use are predetermined, an entity applies the guidance in section 3.3.5 to determine if the customer directs the use of the identified asset. If only some of the relevant decisions about how and for what purpose the asset will be used are predetermined, an entity considers whether the customer has the right to make those remaining (i.e. available), relevant 'how and for what purpose' decisions throughout the period of use. The following diagram illustrates this point.





### Example 3.3.30

#### **Directing the use of identified assets – truck and trailers**

Supplier provides Customer with a truck and three trailers for its exclusive use for three years. The following facts are relevant.

- Supplier cannot substitute the truck or any of the trailers except for servicing or repair.
- Customer keeps the truck and trailers at its location when not in transit or at a delivery point so that it can use the trailers that are not in transit. For example, Customer can load one of the trailers not in transit with cargo so it is ready for transit on return of the truck.
- Customer can use the truck with a trailer not provided by Supplier, and any one of the trailers with a truck not provided by Supplier.
- Customer is responsible for providing a driver for the truck and can decide when and where the truck and trailers go.
- The contract limits Customer's use of the truck to 120,000 miles over the three-year period of use.
- The contract prohibits Customer from using any trailers with Supplier's truck that are larger than those provided by Supplier or hauling loads above a certain weight.

In this example, the contract contains a lease of the truck and three trailers. The truck and the trailers are explicitly specified assets that cannot be substituted except for reasons of servicing or repair – i.e. they are each identified assets.

Customer has the right to control the use of the truck and each of the three trailers during the contract term in the scope of its right of use defined in the contract. Customer has the right to obtain substantially all of the economic benefits from use of the truck and each of the three trailers because it has exclusive use of those assets. Customer also has the right to direct how and for what purpose the truck and trailers are used (i.e. when and where the truck and the trailers go or what they transport) in the scope of the contractually agreed right of use (i.e. subject to Supplier's protective rights). The contractual limits on truck usage are inherent features of the usage rights conveyed by the contract and do not prevent Customer from having the right to direct the use of the truck and trailers.



### Question 3.3.110

#### **Functional independence**

**If an asset does not function independently of other supplier-owned or supplier-leased assets, is that asset still capable of being leased?**

**Interpretive response:** Yes. The Board considered whether to specify that a customer controls the use of an underlying asset only if the asset has stand-alone utility to the customer; that is, only if the customer has the ability to

derive the economic benefits from use of an asset, either on its own or together with other resources that could be sourced in a reasonable period of time. The Board decided that such a requirement should not be part of the definition of a lease. [ASU 2016-02.BC142(c)]

Therefore, an asset's dependency on one or more other assets for the customer to be able to derive economic benefits from use of the asset does not determine whether there is or is not a lease. For example, a contract between an office building owner and a tenant for exclusive use of the 23<sup>rd</sup> floor can still meet the definition of a lease even though the customer's ability to derive benefit from use of the 23<sup>rd</sup> floor depends on, for example, floors 1–22, the elevators used to access the 23<sup>rd</sup> floor, and the common areas through which all occupants of the building (and their visitors) must transit to access their office space.

Similarly, an equipment asset's dependency on a larger network or plant does not preclude there being a lease of that equipment asset.



### Question 3.3.120

#### **Customer-premise identified assets dedicated to the customer**

**Does a lease always exist when the identified asset will function at the customer's premises and the asset exclusively serves the customer?**

**Interpretive response:** No. Even though it frequently will be the case that a lease exists in those circumstances – i.e. when the asset resides at the customer's premises and the customer has either exclusive use of the asset or the asset is dedicated to providing the customer a service – a lease does not *necessarily* exist. This is because the customer may not have the right to direct the use of the identified asset even if it does have the right to obtain substantially all of the economic benefits from its use.

Subtopic 842-10 includes an example (Example 10 Case A) of computer servers located at the customer's premises to provide a dedicated service to the customer, and Example 3.3.40 provides a similar, but more detailed example. In each case, it is determined that a lease does not exist because the supplier has the right to direct the use of the identified assets even though they are located at the customer's premises and exclusively serve the customer.

An example substantially the same as Example 3.3.40 was discussed with the FASB and SEC staffs, who concurred with the conclusion that the example did not contain a lease. As part of those discussions, the FASB staff indicated that the outcome in arrangements of the nature described in this question will require careful application of the lease identification model. Proper determination of (1) the identified asset(s), (2) what relevant decisions are available to be made during the period of use and (3) who controls those decisions will be key to reaching the appropriate conclusion.

The specific facts and circumstances of the arrangement should be considered; however, with respect to Example 10 Case A (in Topic 842) and Example 3.3.40

specifically, we believe the fact that there are multiple identified assets and that each has multiple potential uses within the network services arrangement are important to the conclusion reached. Because there are multiple identified assets in each of those two scenarios, which could be deployed in multiple ways at the supplier's sole discretion, it is appropriate to conclude that the supplier, rather than the customer, controls how and for what purpose the identified assets are used – i.e. directs the use of the identified assets.

In contrast, in a scenario that involves only a single identified asset, and particularly if that asset is designed to perform a single function, it may be that the supplier does not have substantive decision-making rights about how and for what purpose the identified asset is used during the period of use. Rather, it may be that either (1) the customer controls the most relevant how and for what purpose decisions that are available to be made, or (2) all of the relevant how and for what purpose decisions are predetermined and the guidance outlined beginning at section 3.3.5 must be applied.



### Example 3.3.40

#### **Infrastructure-as-a-Service – control over the use of the identified asset**

This example continues from Example 3.2.50; for ease of reference, we have included the full fact pattern in this example as well.

Customer enters into a contract with Supplier to obtain specified network services that are provided through the use of 10 servers and various other networking equipment for five years. The network services provided by Supplier involve assets (servers and other equipment) located at Customer's premises.

The contract between Customer and Supplier requires Supplier to provide network services that meet a specified quality level, which if not met, result in service-level penalties – i.e. credits against amounts owed by Customer to Supplier. Customer controls how and how much it uses the network services, but Customer cannot (under the terms of the contract) change the configuration or specifications of the network (or 'turn off' the network).

The servers and the networking equipment to fulfill the network services are selected by Supplier, and then explicitly specified in the final contract. All of the specified equipment is dedicated to servicing Customer.

Because of this arrangement, Customer chooses not to set up its own network/data center (e.g. acquiring servers and equipment of its own, or potentially hiring IT personnel) or to operate its own network.

Example 3.2.50 concluded that there are identified assets in the arrangement; each server and piece of equipment is an identified asset. Therefore, Customer and Supplier do *not* evaluate the servers and other equipment as a combined unit of account (i.e. as a network). This example explores whether Customer is leasing the identified servers and equipment.

Customer has no rights to change how the servers or other equipment used to provide the network services are used. It cannot, for example, redirect a server or another piece of equipment from the network services to another use or

direct (or change) the role the servers play in the network – e.g. Customer cannot change Server X1's role in the network architecture from hosting Software Y to being configured in another way to host Software X. Supplier solely has the right to change how the equipment is used within the network services agreement with Customer, which it will often do to optimize network performance (particularly over a longer-term arrangement).

The identified assets (i.e. the servers and the other equipment) are not being leased to Customer because Supplier, rather than Customer, controls their use. This conclusion is based on the following.

- **Supplier controls how the identified assets are used.** Even though the identified assets are fully dedicated to Customer's network services, limiting their potential uses to Supplier, the servers each have multiple roles they can play within the network architecture; for example, Server X1 could host Software X or Software Y, be configured to perform Function A or Function B, or process or store data. Customer, in contrast, has no rights to decide (or change), or prevent Supplier from changing (as long as the network services are not interrupted), how the servers are used. That is, although Customer decides how and when it uses the *network*, Customer's decisions do not affect how each identified asset (i.e. each server or other piece of equipment) that comprises the network is used.
- **Supplier controls when, whether and how much the identified assets are used.** Supplier, at its sole discretion, may decide that an identified asset is extraneous to the network and remove it from network service to reduce operating/maintenance costs, or decide that the identified asset be employed to its full capacity. Customer, in contrast, has no right to change whether or when an identified asset is producing output because each identified asset is constantly performing its function within the network unless Supplier decides otherwise. Further, Customer cannot decide to specifically use an identified asset. Customer's use of the network (e.g. accessing a particular hosted application or functionality or stored data) doesn't necessarily employ, for example, Server X1 or Server X2. The network services permit Customer to use the network (e.g. access Application A, perform function B and store/transmit data), but Customer has no right to decide that, for example, Server X1 will host Application A or Server X2 will perform function B. By choosing to, for example, access Application A, Customer does not also choose to use Server X1 because it is Supplier that decides (and can change) which of the identified servers (X1–X10) hosts Application A. Put another way, Customer's decisions are about when, whether and how much to use the network, not one (or some) of the identified assets used to create the network.



#### Example 3.3.45\*\*

#### Supplier-owned fiber-optic telecommunications equipment – control over use

ABC Telecom enters into lit circuit arrangements with third-party suppliers (i.e. fiber network owners) to transmit internet protocol (IP) data.

A lit circuit is comprised of a bundle of individual fiber strands maintained and operated by the network owner (hereafter, Supplier) using Supplier's equipment to light a dark fiber strand (thus denoting a 'lit circuit' versus a 'dark fiber' arrangement). IP data is transmitted over the fiber strand through optical wavelengths.

Suppliers frequently make use of dense wavelength division multiplexing (DWDM) technology. DWDM puts data from different sources together on an optical fiber, with each signal carried at the same time on its own separate light wavelength. Instead of requiring one optical fiber per transmitter and receiver pair, DWDM allows several optical channels to occupy a single fiber optic cable, and therefore multiplies capacity. Using DWDM, up to 80 (and theoretically more) separate wavelengths or channels of data can be transmitted on a single optical fiber. DWDM is enabled by DWDM equipment. To increase capacity on its network, a supplier may replace installed DWDM equipment with DWDM equipment that has additional ports (e.g. swap equipment with 40 channels for equipment with 80 channels) or virtually add capacity to the existing ports through enhanced optical readers.

Lit circuit arrangements often include positioning supplier-owned DWDM equipment on the customer's premises for the term of the arrangement. DWDM equipment will also typically be positioned at other customers' and the supplier's own points of presence. In this example, DWDM equipment is positioned at ABC Telecom's premises, which is at the end of Supplier's network (i.e. at ABC Telecom's head end), when ABC Telecom enters into the lit circuit arrangement with Supplier. ABC Telecom is not leasing the network or the 'last mile' portion thereof that connects to the equipment.

ABC concludes that it is not leasing the supplier-owned DWDM telecommunications equipment in these arrangements. This conclusion is based on the analysis that follows.

#### **Is there an identified asset?**

Yes, the DWDM equipment is a physically distinct piece of equipment from the lit circuit (i.e. the fiber) and is implicitly specified. It becomes implicitly specified when the equipment is connected to the lit circuit and placed in ABC Telecom's head end location given the evaluation of substantive substitution rights below (see paragraph 3.2.30).

Additionally, Supplier does not have a substantive substitution right because, while Supplier has the enforceable right and practical ability to substitute the DWDM equipment being used at ABC Telecom's premises, ABC Telecom and Supplier each conclude, given the costs associated with substituting different DWDM equipment at ABC Telecom's premises, that it is not expected to be economically beneficial for Supplier to substitute the DWDM equipment after installation.

#### **Does ABC Telecom (customer) have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use?**

No. ABC Telecom does not have the right to obtain substantially all of the economic benefits from the use of the DWDM equipment. The DWDM equipment's economic benefits from use principally accrue to Supplier, rather than ABC Telecom.

As described earlier, DWDM technology permits Supplier to increase the capacity of its network without installing additional fiber – i.e. it enables more efficient use of Supplier's fiber network. Not using DWDM would reduce the capacity and efficiency of Supplier's network. The DWDM equipment is what enables DWDM; it arranges different pieces of data from different sources together on the applicable optical fiber, with each data signal carried at the same time on its own separate light wavelength. The output/utility of the equipment is in increasing the number of optical wavelengths, enabling fiber/network efficiency gains.

Therefore, the DWDM equipment is a tool for Supplier to increase its fiber transmission capacity. The DWDM equipment allows Supplier's investment in its fiber plant not only to be preserved, but optimized many times over. As demands change, Supplier has the ability to add more capacity, either by simple equipment upgrades or by increasing the number of wavelengths on the fiber, without expensive upgrades of replacing or adding miles of fiber optic cable.

ABC Telecom, by contrast, derives no specific economic benefit from the use of the equipment because its data transmission could occur regardless of the existence of the equipment (different from a fiber strand or satellite transponder that is actually the asset that carries/transmits the data). Supplier's ability to create additional capacity helps to keep costs for each customer, including ABC Telecom, lower than they would otherwise be if Supplier had to recover its network investment with fewer customers or had to build more infrastructure to support its customer base; but (1) that is concluded not to be an economic benefit *from use* and, (2) even if it were considered an economic benefit from use, it would not negate that Supplier's economic benefit from the use of the DWDM equipment is substantial (more than an insignificant portion of the total economic benefits from use).

#### **Does ABC Telecom (customer) have the right to direct the use of the DWDM equipment?**

Because ABC Telecom does not have the right to obtain substantially all of the economic benefits from the use of the DWDM equipment (i.e. Supplier obtains at least a substantial portion of the economic benefits from use of the DWDM equipment), a lease does not exist under Topic 842. As a result, evaluation of whether ABC Telecom directs the use of the DWDM equipment throughout the period of use is not necessary. However, based on the determined function/output of the DWDM equipment, Supplier controls the decisions relevant to changing that output. Supplier (rather than ABC Telecom) can decide when and whether to use the equipment, and how to configure the equipment to meet its network optimization goals.



#### **Example 3.3.50** **Construction services contract**

ABC Construction Company enters into a contract with Customer to construct a building and a parking garage designed by Customer on Customer's property. The project is expected to take 15–20 months to complete.

The nature of the construction services is such that ABC will use a variety of construction equipment it owns to fulfill the contract. During the construction period, the various pieces of equipment are implicitly specified because ABC will not, under circumstances likely to occur or exist throughout the period of use, economically benefit from substituting the equipment it commits to the project for equivalent equipment during the construction period (the period of use) – see paragraphs 3.2.20 – 3.2.30. Therefore, the pieces of equipment are identified assets.

While the pieces of equipment are identified assets, and implicitly specified to Customer's construction project, Customer does not control their use. At no point during the period of use does Customer have the right to direct how and for what purpose any of the identified equipment is used. While Customer has specified an output from the equipment *as a unit*, Customer has no rights to decide how ABC employs any individual piece of equipment to fulfill the construction contract. Rather, it is ABC that, throughout the period of use, will solely decide how each piece of equipment is used to complete the numerous tasks necessary to fulfill the contract.



### Example 3.3.55\*\*

#### Point-of-sale terminals – right to direct the use of the identified assets

ABC Retailer enters into an electronic payment solutions (i.e. transaction processing) arrangement with Supplier. Supplier will process credit/debit card transactions of customers who make purchases from ABC's store.

The arrangement requires a point-of-sale (POS) terminal to be hosted at ABC's store. A POS terminal is an electronic hardware device used to process credit/debit card payments at merchant locations, such as ABC's store. The POS terminal is the device that connects ABC's store to Supplier's network, and is therefore necessary to process card transactions under the arrangement. It reads information off of an ABC customer's credit or debit card and transmits the information to Supplier's systems for authorization from the Card Issuer and ultimate settlement of the sale back to ABC.

The additional facts are also relevant.

- The POS terminal provided to ABC is only permitted to run Supplier's software and, therefore, can only be used to process card transactions on Supplier's network.
- The POS terminal used by ABC is not specified (e.g. by serial number) in the initial contract with Supplier, but a specific POS terminal is assigned to ABC at the commencement of the arrangement.
- While not stated in the contract, Supplier has an enforceable right to substitute the POS terminal initially assigned throughout the period of use, and is required to do so if it is not operating properly.
- There are no stated fees in the contract related to use of the POS terminal.

In this example, ABC is concluded to be leasing the POS terminal provided by Supplier in this arrangement. This conclusion is based on the analysis that follows.

#### **Is there an identified asset?**

Yes. The POS terminal is a physically distinct piece of equipment and implicitly specified. It becomes implicitly specified when the equipment is delivered to ABC's location at commencement of the arrangement and assigned to ABC given the evaluation of substantive substitution rights below.

Supplier does not have a substantive substitution right. While Supplier has the enforceable right and practical ability to substitute the POS terminal, and must do so if it is not functioning properly, there would not be any likely economic benefit to Supplier from substituting a functioning POS terminal at ABC's store with an equivalent POS terminal. There would be costs to retrieve the assigned POS terminal and deliver a replacement terminal, and it is unlikely that doing so would generate incremental economic benefits (e.g. increased transaction processing fees) from another customer above what Supplier could earn from providing the replacement POS terminal not in use by ABC to that customer.

#### **Does ABC (customer) have the right to obtain substantially all of the economic benefits from use of the identified POS terminal throughout the period of use?**

Yes. ABC has the right to obtain substantially all of the economic benefits from use of the POS terminal throughout the period of use (which is the contract term). The economic benefits from use of the POS terminal are its ability to process card transactions; there are no by-products or other economic benefits from use. ABC has exclusive use of the POS terminal; no other party's card transactions will be processed by the POS terminal during the period of use.

#### **Does ABC (customer) have the right to direct the use of the identified POS terminal?**

Yes. ABC has the right to direct how and for what purpose the POS terminal is used throughout the period of use. ABC is not permitted to use the POS terminal to process transactions on a network other than Supplier's, and Supplier's substitution right is not considered to be substantive such that Supplier cannot use the POS terminal for another purpose. Therefore, what output the POS terminal will produce – i.e. processing card transactions on Supplier's network – cannot be changed during the period of use.

Consequently, the decisions about when, whether and how much output the POS terminal produces – i.e. when, whether and how many card transactions it processes – are the relevant decisions that most significantly affect the economic benefits to be derived from its use. Those decisions are not predetermined at the beginning of the period of use.

While ABC's customers ultimately decide when and whether to make purchases from ABC's store using a credit/debit card, ABC significantly affects those decisions through its decisions about store operating hours, pricing of goods in the store and which credit/debit cards to accept (if any). For example, ABC could significantly influence customer card use in its stores through discounts for using cash (versus cards), limiting which cards it will accept (or

none), operating more or fewer hours, or having a sale. By contrast, Supplier has no influence on those decisions.



### Question 3.3.130

#### Leases when the supplier has physical possession of, operates and maintains the identified asset

#### Does a lease exist if a supplier has physical possession of, operates and maintains the identified asset?

**Background:** Question 3.3.120 and Examples 3.3.40 and 3.3.50 focus on situations in which an asset located at the *customer's* premises and dedicated to the customer may *not* result in a lease. In contrast, this question and Examples 3.3.60 and 3.3.70 focus on situations where the supplier retains possession of the asset and typically operates and maintains the asset.

**Interpretive response:** It depends. Example 9 Case C in Subtopic 842-10 illustrates a scenario where a customer leases a power plant that the power plant owner (i.e. the supplier) controls physical access to, operates and maintains. Therefore, it is clear that a lease can exist in such circumstances. [842-10-55-117 – 55-123]

In that example, the customer controls when, whether and how much electricity the power plant produces, and those 'how and for what purpose' decisions most significantly affect the economic benefits that will be derived from use of the power plant.

A customer may have similar rights to control the use of an identified factory or dedicated production line in some contract manufacturing scenarios. The factory or dedicated production line may be operated, maintained and controlled as to physical access by the manufacturer, but the customer may have the right to control the economic benefits derived from use of the identified asset by virtue of having the right to dictate when, whether and how much the factory or the line produces. For example, a factory or a dedicated production line may comprise integrated, specialized equipment for the production of the customer's product and may only produce the customer's product on the basis, and only to the extent, of customer purchase orders issued each month or quarter during the contract period.

As another example, the fact that the computer server in Example 10 Case B in Subtopic 842-10 is leased does not depend on the fact that it resides at the customer's premises. A customized or specialized server maintained at the supplier's premises could also be an identified asset, and the customer could be deemed to control that asset if it had the right to direct (and change), for example, what software the server would host or what functions it was configured to perform throughout the period of use.

In more complex scenarios, the asset owner and the customer may each have substantive decision-making rights. For example, the contract manufacturer in the factory/production line discussion may have the right to decide *when* to operate the factory or the line – i.e. the manufacturer may receive orders from the customer dictating the total quantity to be produced – but have flexibility to

decide whether to produce those orders immediately by running the factory or the line at maximum capacity until the order is fulfilled or continuing to run the asset at normal capacity.

However, in that type of scenario, we would generally consider decisions about *when* to produce output, which the manufacturer controls, as being less relevant than decisions about whether to produce output and how much output to produce, which the customer controls. And in some cases, the customer may be able to implicitly control the ‘when’ as well as the ‘whether’ and ‘how much’ decisions if it can, in effect, dictate the level and timing of production by its orders – e.g. if the customer can issue purchase orders of a quantity or subject to a deadline that overrides the manufacturer’s nominal right to decide when to fulfill the customer’s orders.

Significant judgment may be required in these types of scenarios, including careful consideration of which decisions each party controls and which of those decisions are most relevant – i.e. most significantly affect the economic benefits that can be derived from use of the asset.



### Example 3.3.60

#### **Right to direct the use of the identified asset – outsourcing arrangement**

##### **Scenario 1: Customer can change the mix and quantity of output during the period of use**

Continuing Example 3.3.10, Scenario 2, Supplier designed and constructed the factory that will produce the airbags specifically to meet Customer’s demand. The factory is a single, integrated asset of the nature described in Question 3.2.10; it is specified in the contract and Supplier does not have the practical ability to source the airbags from another factory.

In addition, the factory is designed to manufacture airbags of various types and quality and Customer has the right to direct (and change) the mix and quantity of airbags that the factory produces during the period of use. Because Customer controls the mix and quantity of airbags produced, it also implicitly controls when the factory produces airbags.

Customer has the right to direct the use of the factory because it directs (and can change) how and for what purpose the factory is used – Customer can change the type and quantity of output produced by the factory. Because the factory is an identified asset and Customer also has the right to obtain substantially all of the economic benefits from the use of the factory (see Example 3.3.10, Scenario 2), the arrangement contains a lease.

##### **Scenario 2: Customer can change the output quantity only during the period of use**

Changing the facts of Scenario 1, the factory, as designed, can only produce the particular type and quality of airbag requested by Customer in the contract – i.e. the factory cannot produce other types of output. However, consistent with the facts in Scenario 1, Customer has the right to decide (and change) the quantity of airbags produced by the factory during the period of use. Supplier controls

when it produces the airbags Customer orders – e.g. whether it runs the factory at maximum capacity for 12 hours per day to fulfill Customer's orders or at a lesser capacity for 16 hours per day – subject to meeting contractually agreed production timelines.

Neither Customer nor Supplier can change what the factory produces because the factory was designed to produce only the particular type and quality of airbags requested by Customer in the contract. However, Customer decides whether and how much output the factory will produce, which are the relevant decisions about how and for what purpose the asset will be used that are available to be made during the period of use.

Supplier nominally controls when to produce the airbags as long as it meets contractually agreed delivery requirements. However, those decisions are less relevant to the economic benefits that can be derived from use of the factory than the decisions about whether and how much output the factory will produce that Customer controls. In addition, Customer can effectively override Supplier's decision-making rights about when to run the factory by issuing purchase orders that effectively require Supplier to run the factory at maximum capacity to meet the agreed production timeline.

Because Customer has the right to make the most relevant decisions about how and for what purpose the factory will be used throughout the period of use that are not predetermined by the design of the factory, Customer has the right to direct the use of the factory. The factory is an identified asset and Customer controls its use – i.e. it has the right to both direct its use and obtain substantially all of the economic benefits from its use, therefore, the arrangement contains a lease.

The conclusion to this scenario is significantly similar to that reached in Example 9 Case C in Subtopic 842-10. [842-10-55-117 – 55-123]



### Example 3.3.62

#### **Construction subcontractor arrangement (1) – scaffolding**

ABC Construction (Customer), the primary contractor on the construction of an office building, enters into a contract with a subcontractor (Supplier) to provide a specified quantity of scaffolding, to be erected as and where needed in active areas of construction throughout the construction period.

Supplier provides the scaffolding and all services to maintain, erect and remove the scaffolding. As construction progresses, Customer has the right to change where and whether the scaffolding is erected. At the end of the construction period, Supplier will remove all of the scaffolding from the construction site.

Customer and Supplier each analyze whether the contract contains a lease of the scaffolding. They first conclude that the scaffolding is an identified asset because:

- it is a physically distinct item of property, plant or equipment; and
- once delivered to the construction site, Supplier will not benefit economically from substituting equivalent scaffolding.

Customer and Supplier next consider whether Customer controls the use of the scaffolding.

- They first determine that Customer has the right to obtain substantially all of the economic benefits from use of the scaffolding. This is because there are no other parties that will benefit from its use during the construction of the building. The scaffolding will solely be used to complete Customer's construction project and its use in that task is its sole economic benefit from use.
- They then evaluate whether Customer or Supplier has the right to direct and change how and for what purpose the scaffolding is used, or whether such decisions are predetermined.

Relevant how and for what purpose decisions	Considerations	Who controls the relevant decision or is it predetermined?
<b>Where</b>	The scaffolding will be used only at the Customer's construction site, but can be deployed at various places on the site.	Customer controls the part of the project to which the scaffolding is deployed.
<b>What</b>	The scaffolding will be used solely for construction purposes at Customer's construction site. However, decisions remain about what part of the overall project Supplier's scaffolding will be used in.	Customer controls the part of the project to which the scaffolding is deployed.
<b>When, whether and how much</b>	The scaffolding may not be erected and in use throughout the entire construction period – e.g. it may remain idle between various stages of the project.	Customer decides when and whether to erect, take down and move the scaffolding; and on which parts of the overall construction project to use it.

Based on this analysis, there are relevant how and for what purpose decisions available to be made and changed during the period of use, and Customer controls those relevant decision-making rights. Therefore, Customer has the right to direct the use of the scaffolding.

Because the scaffolding is an identified asset and Customer controls its use, Customer is leasing the scaffolding in this example.



### Example 3.3.65

#### Right to direct the use of the identified asset – shipping spot charter

Ship Co (supplier) enters into a contract with Oil Co (customer) to transport Oil Co's unrefined oil from the US coast of the Gulf of Mexico to East Asia aboard a specified tanker ship that cannot be substituted by Ship Co without Oil Co's

permission. The duration of the contract is a single voyage between these two regions.

The tanker ship has a defined capacity that cannot be exceeded and the ship is designed to transport petroleum products; it is not suitable for other types of cargo.

The following are relevant facts about each party's rights and obligations under the contract.

<b>Fees</b>	Oil Co will pay Ship Co a minimum fee for the voyage. That fee can increase if Oil Co exercises one or more of its various rights to change the voyage – e.g. extend the length of the voyage.
<b>Operation and maintenance</b>	Ship Co will operate and maintain the ship. Oil Co has no right to either operate or maintain the ship itself or to replace Ship Co with another operator.
<b>Load port</b>	Oil Co has the right to select any one of four Gulf of Mexico ports in the United States as the load point for the voyage, and can change that decision up until the ship is within one day of the then-selected load port. However, if Oil Co's changes to the load port delay loading beyond the date range specified in the contract, Oil Co must pay Ship Co incremental fees.  Oil Co has storage facilities at each of the four ports where it stores oil from its exploration and production (E&P) operations. At any point in time, Oil Co's facilities at a given port may be more or less stocked with product and different ports may have different product stored – e.g. heavier versus lighter, sweeter crude oil.
<b>Discharge port</b>	Oil Co has the right to select from one of a select number of East Asia ports as the unloading (i.e. discharge) point for the voyage, and can change that decision up until the ship is within one day of the then-selected discharge port. Similar to the requirements for the load port, if Oil Co's changes to the discharge port extend the duration of the voyage, Oil Co must pay Ship Co incremental fees.
<b>Cargo</b>	Oil Co is permitted to load Ship Co's ship with either one or two grades of unrefined oil. However, the tanker ship is not outfitted to transport cargo other than oil or more than two grades of oil at the same time. Oil Co is prohibited under the terms of the contract from transporting certain grades of oil for supplier protective reasons.
<b>Loading and unloading</b>	Once the ship reaches the final load or discharge port, Oil Co has three days' lay-time to load or discharge its cargo. Oil Co can choose to delay loading or unloading beyond the three days on either end of the voyage, but Oil Co will owe Ship Co a charge for detaining the ship (i.e. demurrage).
<b>Capacity</b>	Oil Co is permitted to use as much of the ship's cargo capacity as it chooses; however, as a practical matter, Oil Co would not use less than the ship's capacity because its fee to Ship Co does not change based on how much of the ship's cargo capacity Oil Co uses during the voyage.

In this example, both parties conclude that the contract contains a lease of the tanker ship. This conclusion is based on the analysis that follows.

### **Is there an identified asset?**

Yes. The tanker ship is explicitly specified in the contract and cannot be substituted without Oil Co's permission.

### **Does Oil Co (customer) have the right to obtain substantially all the economic benefits from use of the identified ship?**

Yes. The economic benefits from use of the tanker ship are those derived from the ship's ability to store and transport petroleum products.

From the later of the following dates, no other entity (including Ship Co) may use the identified tanker ship to store or transport its petroleum products:

- the discharge date of the previous Ship Co customer; and
- inception of the spot charter contract between Ship Co and Oil Co.

Therefore, Oil Co has exclusive access to the tanker ship's economic benefits from use.

### **Does Oil Co (customer) have the right to direct the use of the identified ship?**

Yes. In reaching this conclusion, Ship Co and Oil Co first evaluate whether there are relevant 'how and for what purpose' decisions available to be made during the period of use; or instead, whether all of the relevant how and for what purpose decisions about the use of the ship are predetermined.

The following table evaluates whether there are 'how and for what purpose' decisions available to be made during the period of use (see paragraph 3.3.260) and whether those decisions are both relevant (see paragraphs 3.3.180 – 3.3.190 and 3.3.230) and substantive (see Question 3.3.30).

<b>How and for what purpose examples in Topic 842 (see paragraph 3.3.200)</b>	<b>How and for what purpose decision-making rights available to be made during the period of use</b>
<b>The right to change the type of output that is produced by the asset</b>	<p>Yes, but limited. Decisions about what output the ship will produce are mostly predetermined by the design of the ship (can only transport petroleum products) or the contract (limits the petroleum products Oil Co can transport using the ship). However, what output the ship will produce is not entirely predetermined because Oil Co can select from a range, albeit limited, of petroleum products to transport (i.e. Oil Co is not limited to transporting only one grade of crude oil) and has the option to transport one or two grades of oil. Oil Co's decision-making rights in this regard end after the ship is loaded – i.e. Oil Co cannot change the cargo once it has been loaded – but it can be changed until that time.</p> <p>While the cargo flexibility is limited, the flexibility in terms of grade and whether to load a single grade or two grades affects the economic benefits from use of the ship because Oil Co can use that flexibility to manage its resources and/or arbitrage between different prices of grades of oil.</p>

<b>How and for what purpose examples in Topic 842 (see paragraph 3.3.200)</b>	<b>How and for what purpose decision-making rights available to be made during the period of use</b>
	<p>These relevant decision-making rights are substantive. While Ship Co is unable to know what decisions Oil Co will make, customers of Ship Co (and others) frequently exercise their right to select from multiple types of product or to transport two grades of oil versus only one.</p>
<b>The right to change when the output is produced</b>	<p>Yes, but limited. Oil Co has only limited rights to change when the output is produced – i.e. within a relatively narrow date range. For example:</p> <ul style="list-style-type: none"> <li>— For additional fees, Oil Co can affect the time to load or discharge product from the ship.</li> <li>— For additional fees, Oil Co could direct the ship to lay idle during the voyage and thereby extend its duration.</li> <li>— Oil Co is permitted to instruct Ship Co to speed up or slow down the ship (within a narrow range), which could shorten or lengthen the duration of the voyage.</li> </ul> <p>Oil Co does not have the practical ability to extend or shorten the voyage significantly – e.g. by weeks or months.</p> <p>Oil Co's economic benefits from use of the ship are affected if it must pay additional fees to Ship Co based on these decisions. Further, the available decisions may affect Oil Co's ability to sell the oil to a particular customer and/or its ability to effectively supply its refineries. Customers frequently exercise these rights and the effect of these decisions on a customer's economic benefits from use is substantive.</p>
<b>The right to change whether the output is produced and the quantity of that output</b>	<p>Yes. Legally, Oil Co has the right to transport an amount of oil that does not use the full capacity of the ship.</p> <p>This is not a substantive decision-making right (see Question 3.3.30). While Oil Co could choose to sail the ship empty or under capacity, it is not practically a viable economic decision. Therefore, while relevant, because non-substantive, decisions about whether and how much output the ship will produce are effectively predetermined by the design of the ship.</p>
<b>The right to change where the output is produced</b>	<p>Yes. Oil Co has the right to direct and change the load and discharge ports for the voyage.</p> <p>These decisions are substantive as evidenced by customers' frequent exercise of these decision-making rights. Furthermore, they are relevant based on the following.</p> <ul style="list-style-type: none"> <li>— Having multiple discharge options, even if limited to a particular region or a single country, together with the fluctuating nature of the price of oil, permits customers additional flexibility to trade the oil (e.g. expands their population of possible customers) or to direct the cargo to its own facilities based on current supply needs.</li> <li>— Having multiple load options, even if also limited to a particular region or a single country, may permit the customer to select from different grades of oil (if the contract, such as the one between Ship Co and Oil Co,</li> </ul>

<b>How and for what purpose examples in Topic 842 (see paragraph 3.3.200)</b>	<b>How and for what purpose decision-making rights available to be made during the period of use</b>
	permits that) and match transport with production output and supply needs.

Based on the analysis, there are substantive, relevant how and for what purpose decisions available to be made during the period of use. Oil Co controls those decisions in each case; Ship Co does not control any of the available decisions. Consequently, Oil Co has the right to direct the use of the identified tanker ship.



### Example 3.3.70

#### **Right to direct the use of the identified asset – storage warehouse(s)**

##### **Scenario 1: Continuation of Example 3.2.20**

Continuing Example 3.2.20, Customer enters into a five-year arrangement with Supplier for a climate-controlled storage warehouse in which to store its coffee beans and/or other products. The storage warehouse is specified in the contract (storage warehouse 3C), Customer has exclusive use of the warehouse, and Supplier has no right to substitute it. Therefore, there is an identified asset.

A warehouse is typically a warehouse by design; it could not be a retail unit or office building without substantially modifying the asset. Therefore, its output is storage and the relevant how and for what purpose decisions – i.e. those that significantly affect the economic benefits to be derived from use – are what the warehouse stores and when, whether and how much the warehouse stores.

Customer determines throughout the period of use what to store in the warehouse (e.g. coffee and/or tea, subject to a restriction on the storage of hazardous materials), the quantity to be stored (up to a maximum quantity), and how much of the warehouse it will use. Supplier operates and maintains the storage warehouse.

The contract contains a lease. Customer has the right to obtain substantially all of the economic benefits from the use of the identified storage warehouse because it has exclusive use of it. Customer also has the right to direct the use of the storage warehouse because it has the right to direct how and for what purpose it is used throughout the period of use. That is, Customer has the right to determine the type and quantity of output that the asset produces throughout the period of use, which in the case of the warehouse is what it stores (even if that is restricted by the contract – e.g. restrictions may exist on things like hazardous or flammable materials) and when and how much it stores.

##### **Scenario 2: Multiple warehouses**

In this scenario, Supplier agrees to dedicate multiple discrete warehouses for Customer's use. Supplier can decide what Customer goods are stored in which of the dedicated warehouses, as well as the storage location of Customer's

goods within the selected warehouse. Likewise, Supplier has full discretion to move items both within and among the dedicated warehouses without Customer's knowledge or consent as long as doing so in no way restricts Customer's ability to access its stored items.

The contract contains a lease. Customer can still control what is stored by deciding, for example, to only store one type of good in the warehouses, and also still controls when, whether and how much is stored – e.g. Customer can decide when, whether and how much all of the dedicated warehouses are used by storing enough goods to require such usage.



### Example 3.3.75

#### **Right to direct the use of the identified asset – advertising on a bus**

ABC Advertising Company enters into a contract with a transit authority to place advertising on the sides of city buses. The advertising may be attached to the sides of the buses adhesively (i.e. 'wrapped') or may be placed in frames owned by ABC that are then affixed to the buses.

ABC also enters into a contract with Customer to display Customer's advertising on the sides of city buses. The following facts are relevant to ABC's contract with Customer:

- ABC and the transit authority have the right to approve the advertising content;
- The contract stipulates the number of buses on which the advertising will be placed, but ABC determines which specific buses get the advertising and the related routes those buses will run;
- ABC makes no express or implied promise or commitment that Customer's advertising will be displayed on any specific bus or bus route;
- ABC solely determines whether the advertising will be wrapped or placed in an affixed frame;
- ABC has the discretion to move Customer's advertising onto different buses and routes and to change how the advertisements are attached to the buses (i.e. wrapped versus frame).

#### **Evaluation of ABC as lessee of the advertising space**

ABC's contract with the transit authority is not a lease because ABC does not control the use of an identified asset in this contract. Consistent with the discussion in Question 3.2.40, ABC concludes that the side of a bus where ABC has the right to display customers' advertising is not a physically distinct, identifiable asset. Rather, the bus is the identified asset and ABC does not through this contract have the right to control its use – i.e. either (1) obtain substantially all of its economic benefits from use, or (2) direct its use.

## Evaluation of ABC as lessor of the advertising space

### **Scenario 1: Advertising is wrapped**

In the scenario where ABC wraps Customer's advertising on the side of a bus, the contract between ABC and Customer does not contain a lease. This is because ABC neither owns the bus (i.e. the transit authority does), nor is it leasing the advertising space on the side of the bus from the transit authority (see *Evaluation of ABC as lessee of the advertising space*). Because ABC does not own or lease the advertising space itself, it cannot lease or sublease that space to Customer. ABC is effectively reselling the service it is receiving from the transit authority of providing advertising space on the transit authority's buses to Customer.

### **Scenario 2: Advertising is placed in an affixed frame**

ABC's decision about whether to wrap or affix Customer's advertising to a transit authority bus in a frame does not alter the fact that neither ABC (from transit authority) nor Customer (from ABC) is leasing the side of that bus.

However, if ABC affixes Customer's advertising to the bus in a frame that ABC owns, there is an identifiable item of equipment (i.e. the ABC-owned frame) – see Question 3.2.40.

Even though ABC owns the frame, the advertising contract between ABC and Customer does not contain a lease of the frame by Customer. This is because Customer has no right to direct how and for what purpose the frame is used. Customer cannot require ABC to change the advertising in the frame and, in fact, cannot require ABC to continue to use that frame at all. ABC retains the sole ability at all times to decide whether the frame is used for Customer's advertising, for another customer's advertising, or not at all.

Furthermore, the frame may not even be an identified asset. Although the frame is *identifiable*, ABC may, depending on the facts and circumstances, have a substantive substitution right. This is because ABC regularly changes how and where it places advertisements to maximize its use of the space (sides of buses) it obtains from the transit authority. Circumstances in which ABC would economically benefit from such changes may be considered 'likely to occur' (see paragraph 3.2.130 and Example 3.2.30), especially given the low costs of making the changes. And when ABC does so, it has no obligation to continue to present the customer's advertising in the same frame (or in a frame at all).



### Example 3.3.76

#### **Right to direct the use of the identified asset – billboards**

### **Scenario 1: Stationary traditional billboard**

ABC Corp. (Customer) enters into a three-year contract with XYZ Stadium Corp. (Supplier) to display its advertisement on a stationary, traditional (i.e. non-digital) billboard owned by Supplier and located in Supplier's baseball stadium.

The billboard is specified in the contract, and Supplier does not have any substitution rights. Customer has exclusive use of the billboard, and can

unilaterally decide (and change) what content is displayed on the billboard throughout the contract period, subject to provisions that preclude Customer from displaying certain content – e.g. political or religious messages, support for other sports teams, inappropriate material.

Both parties conclude that there is a lease of the billboard based on the following.

- There is an identified asset. The billboard is explicitly specified in the contract and Supplier does not have any substitution rights.
- Customer has the right to obtain all of the economic benefits from use of the billboard during the period of use. The economic benefits from use are solely its output of displaying advertising. Customer has exclusive rights to that output throughout the contract period.
- Customer has the right to direct the use of the billboard throughout the period of use. This is because it determines and can change, throughout the period of use, when, whether and what the billboard displays. The contractual restrictions on the content Customer can display are protective in nature, and not so restrictive that they preclude Customer from directing the use of the billboard (see Question 3.3.20).

### **Scenario 2: Digital billboard**

Assume the same facts as in Scenario 1, except the billboard is digital rather than traditional. Whether the billboard is digital or traditional has no bearing on its own on the evaluation of whether a lease exists. Therefore, for the same reasons as Scenario 1, a lease exists.

### **Scenario 3: Sub-divided traditional billboard**

Assume the same facts as in Scenario 1, except that Customer has the right to only one-third of the billboard's display space, and that third is specified in the contract.

Supplier has the contractual right to substitute an alternative section of the billboard. However, that right is not substantive because it is not likely that Supplier would economically benefit from substituting one homogenous section of the billboard for another. That is, it is not likely that another customer would be willing to pay more to obtain rights to display on Customer's section of the billboard versus a homogenous alternative section.

Customer has exclusive use of its specified section of the billboard, and can solely decide (and change) what content is displayed on the billboard throughout the contract period, subject to the same restrictive provisions outlined in Scenario 1.

Both parties conclude that there is a lease of the specified billboard section based on the following.

- There is an identified asset. The specified section of the billboard is explicitly specified in the contract<sup>1</sup> and Supplier does not have a substantive substitution right. In reaching this conclusion, the parties also consider that the billboard's primary purpose is to display advertising and has been designed to permit multiple customers to use the billboard's available display space (see Question 3.2.40).

*Note:* The conclusion that there is an identified asset would not change if the section of the billboard to be used by Customer was not explicitly specified in the contract, but rather becomes specified at the time Customer is first ready to display an advertisement on the billboard.

- Customer has the right to obtain all of the economic benefits from use of the billboard section during the period of use. These economic benefits are solely its output of displaying advertising. Customer has exclusive rights to that output throughout the contract period.
- Customer has the right to direct the use of the billboard section throughout the period of use. This is because it determines, throughout the period of use, when, whether and what the billboard section displays. The contractual restrictions on the content Customer can display do not affect this conclusion for the same reasons explained in Scenario 1.

#### **Scenario 4: Rotating digital billboard (1)**

Assume the same digital billboard as in Scenario 2 with the following additional facts.

- The billboard displays advertising only while there are events playing at the stadium.
- Customer has the right to 1 minute of display time each 10 minutes during the event – i.e. on a rotating basis.
- Supplier retains the right to sell the other 9 minutes to other customers (in any increments it chooses) or to use that time itself (e.g. to advertise upcoming events).
- The total number of minutes of display time is not known because the total number of baseball games and other stadium events is not known, and the duration of events can vary significantly.
- Supplier controls the order in which it displays content during each 10-minute interval, and can change the order as it sees fit. As a practical matter, however, it does not typically change the order during a single event.
- Supplier can replace the digital billboard, but would not economically benefit from doing so absent malfunction. Supplier cannot relocate the billboard from its prominent location or move Customer from that billboard to another one without Customer's permission.

Both parties conclude that there is a lease based on the following.

- There is an identified asset. The billboard is explicitly specified in the contract and Supplier does not have a substantive substitution right.
- Customer has the right to obtain all of the economic benefits from use of the billboard during the non-consecutive period of use. These economic benefits are solely its output of displaying advertising. Customer has exclusive rights to that output throughout the period of use, which is the sum of the non-consecutive 1-minute display periods allotted to Customer under the contract (see Question 5.3.90).
- Customer has the right to direct the use of the billboard throughout the non-consecutive period of use. This is because it determines and can

change, throughout that period of use, whether and what the billboard displays. While Supplier can decide (and change) which 1-minute slot Customer gets during each 10-minute rotation, those decisions are less relevant than the how and for what purpose decisions Customer controls. The contractual restrictions on the content Customer can display do not affect this conclusion for the same reasons explained in Scenario 1.

#### Scenario 5: Rotating digital billboard (2)

Assume the same digital billboard as in Scenario 4 except that Customer has the right to a total of 3 minutes of display time at each stadium event, and Supplier decides (and can change) what 3 minutes Customer gets during any game or event.

Despite this difference from Scenario 4, both parties still conclude there is a lease of the digital billboard.

They conclude there is an identified asset and that Customer has the right to obtain all of the economic benefits from use of the billboard during the non-consecutive period of use for the same reasons as in Scenario 4.

They also conclude Customer has the right to direct the use of the billboard throughout the non-consecutive period of use. Supplier's control over which content is displayed at which times during stadium events is more meaningful than in Scenario 4 – i.e. because Customer's (and similar customers') advertising does not rotate on a continuous cycle throughout the event. However, Supplier's control over when Customer's period of use occurs during each event does not change that Customer's decisions about whether to display content and what content to display during its period of use more significantly affect the economic benefits from use of the digital billboard during the non-consecutive period of use and therefore are more relevant (see paragraph 3.3.180).

In addition, the parties note that if different game or event display slots commanded differential pricing, customers (including Customer) would not be indifferent to the slot they were provided and Supplier would not have unlimited discretion to change Customer's 3-minute display slot from event to event. This reinforces that Customer's decision-making rights about whether to display content during its slot at each event, and what that content is, means Customer controls how and for what purpose the billboard is used throughout the non-consecutive period of use.



**Question 3.3.140**  
**Control over the use of pipeline laterals**

#### Does a customer control the use of an identified pipeline lateral?

**Background:** As discussed in Question 3.2.30, pipeline laterals are physically distinct, identified assets.

**Interpretive response:** It depends. A customer's measure of control over a pipeline lateral can vary significantly from one contract to another, and typically the contract refers to the pipeline owner's obligation to transport product (e.g. natural gas, oil) on the lateral up to the maximum commitment in the contract and makes no reference to the lateral.

In some transportation contracts, even though a physically distinct lateral is constructed to serve the customer (who may be a downstream or upstream customer), the pipeline owner retains the right to control the flow of product into and out of the lateral. Consequently, the pipeline owner is able to store product in the lateral and call on that product either to manage use of the pipeline network as a whole – e.g. to manage the overall compression of a natural gas pipeline network, the pipeline owner may push or pull gas into or out of a lateral – or to supply another customer. The pipeline owner may also have the right to construct new laterals off the existing lateral without the customer's consent.

In such cases, we do not believe the transportation customer has the right to control the use of the lateral. That is, the pipeline owner has the right to both:

- obtain significant economic benefits from use of the lateral – the pipeline owner gets significant economic benefits from being able to use the lateral for its own pipeline management and storage purposes.
- direct the use of the lateral – even if the customer does not call or send product, the pipeline owner has the right, at its sole discretion, to decide when, whether and how much product is stored in or transits the lateral.

In other transportation contracts, the customer may control when, whether and how much product enters, transits, and/or is stored in the lateral. For example, the customer may control the valve (or similar mechanism) that permits product to enter and transit the lateral. If the customer has dispatch rights of that nature and has exclusive rights to the product it calls, the lateral scenario is substantially equivalent to that of the power plant in Example 9 Case C in Subtopic 842-10. In that example, there is a lease of the power plant to the customer because the customer decides when, whether and how much electricity the plant will produce and has rights to all such electricity produced.  
[\[842-10-55-117 – 55-123\]](#)

The Board discussed pipeline lateral lease considerations at a May 2017 public meeting, the Board members' views were consistent with this interpretive response.



### Question 3.3.150 Control over the use of identified 'last mile' assets

#### When does a customer control the use of an identified last mile asset?

**Background:** Question 3.2.30 discussed when the last mile of a single, contiguous asset would be a physically distinct, identified asset.

**Interpretive response:** It depends. Consistent with the discussion in Question 3.3.140 on pipeline laterals, it may be that the customer at the end of the identified last mile asset controls when, whether and how much that asset is used – i.e. in effect has dispatch rights to decide how much electricity, data or traffic transits the last mile asset.

For example, customer control of the switch/valve/breaker that mechanically separates the last mile asset (see Question 3.2.30) – which may or may not involve the customer actually operating the switch/valve/breaker – may provide the customer with the dispatch rights. In such cases, the customer has the right to direct the use of the last mile asset because it directs (and can change) how and for what purpose the asset is used.

In contrast, if the asset owner controls when, whether and how much the asset is used – e.g. because it controls the switch/valve/breaker that mechanically separates the identified last mile asset, there is no lease of the last mile asset because the customer does not direct the asset's use. Rather, the asset owner directs its use.

### 3.3.5 Step 4: Control when the 'how and for what purpose' decisions are predetermined



#### Excerpt from ASC 842-10

##### 55 Implementation Guidance and Illustrations

###### General

- > Illustrations
- > Illustration of Identifying a Lease
- • > Example 5—Truck Rental

**55-72** Customer enters into a contract with Supplier for the use of a truck for one week to transport cargo from New York to San Francisco. Supplier does not have substitution rights. Only cargo specified in the contract is permitted to be transported on this truck for the period of the contract. The contract specifies a maximum distance that the truck can be driven. Customer is able to choose the details of the journey (speed, route, rest stops, and so forth) within the parameters of the contract. Customer does not have the right to continue using the truck after the specified trip is complete.

**55-73** The cargo to be transported and the timing and location of pickup in New York and delivery in San Francisco are specified in the contract.

**55-74** Customer is responsible for driving the truck from New York to San Francisco.

**55-75** The contract contains a lease of a truck. Customer has the right to use the truck for the duration of the specified trip.

**55-76** There is an identified asset. The truck is explicitly specified in the contract, and Supplier does not have the right to substitute the truck.

**55-77** Customer has the right to control the use of the truck throughout the period of use because:

- a. Customer has the right to obtain substantially all of the economic benefits from the use of the truck over the period of use. Customer has exclusive use of the truck throughout the period of use.
- b. Customer has the right to direct the use of the truck. How and for what purpose the truck will be used (that is, the transport of specified cargo from New York to San Francisco within a specified time frame) are predetermined in the contract. Customer directs the use of the truck because it has the right to operate the truck (for example, speed, route, and rest stops) throughout the period of use. Customer makes all of the decisions about the use of the truck that can be made during the period of use through its control of the operations of the truck.

**55-78** Because the duration of the contract is one week, this lease meets the definition of a short-term lease.

• • > Example 6—Ship

• • • > Case A—Contract Does Not Contain a Lease

**55-79** Customer enters into a contract with a ship owner (Supplier) for the transport of cargo from Rotterdam to Sydney on a specified ship. The ship is explicitly specified in the contract, and Supplier does not have substitution rights. The cargo will occupy substantially all of the capacity of the ship. The contract specifies the cargo to be transported on the ship and the dates of pickup and delivery.

**55-80** Supplier operates and maintains the ship and is responsible for the safe passage of the cargo onboard the ship. Customer is prohibited from hiring another operator for the ship or operating the ship itself during the term of the contract.

**55-81** The contract does not contain a lease.

**55-82** There is an identified asset. The ship is explicitly specified in the contract, and Supplier does not have the right to substitute that specified ship.

**55-83** Customer has the right to obtain substantially all of the economic benefits from use of the ship over the period of use. Its cargo will occupy substantially all of the capacity of the ship, thereby preventing other parties from obtaining economic benefits from use of the ship.

**55-84** However, Customer does not have the right to control the use of the ship because it does not have the right to direct its use. Customer does not have the right to direct how and for what purpose the ship is used. How and for what purpose the ship will be used (that is, the transport of specified cargo from Rotterdam to Sydney within a specified time frame) are predetermined in the contract. Customer has no right to change how and for what purpose the ship is used during the period of use. Customer has no other decision-making rights about the use of the ship during the period of use (for example, it does not have the right to operate the ship) and did not design the ship. Customer

has the same rights regarding the use of the ship as if it were one of multiple customers transporting cargo on the ship.

••> 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.

3.3.270 It is possible that neither the customer, nor the supplier, controls relevant decisions (i.e. those decisions that can significantly affect the economic benefits to be derived from use of the asset) about how and for what purpose an identified asset will be used throughout the period of use because those decisions are predetermined. In that case, the customer nevertheless has the right to direct the use of the asset if: [842-10-15-20(b)]

- it has the right to operate the asset or direct others to operate it in a manner it determines throughout the period of use (and the supplier has no right to change those operating decisions); or
- it designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

3.3.280 The relevant decisions about how and for what purpose an asset is used can be predetermined in a number of ways – e.g. by the design of the asset or by the terms of the contract, such as through contractual restrictions on the use of the asset. [842-10-15-21]



### Observation

#### **Decisions about how and for what purpose the asset is used are predetermined in the contract**

3.3.290 The Board expects relatively few cases in which all of the substantive decisions about how and for what purpose the asset will be used will be predetermined in the contract. During deliberations of Topic 842, some Board members observed that someone must control the use of an asset; therefore, if all of the substantive how and for what purpose decisions have been predetermined, it is reasonable to ascribe control over the use of the asset to the customer if it effectively predetermined those decisions by control over the design of the asset, or it controls the operational decisions that remain after the relevant how and for what purpose decisions have already been made.

[ASU 2016-02.BC138-BC140]

3.3.300 After the Board reached this decision, some entities suggested that the supplier should be deemed to control the use of the asset if its right to operate the asset more significantly affects the economic benefits to be derived from use of the asset than the customer's involvement in design. However, the final guidance is clear that the customer will be deemed to control the use of the asset if it either has the right to operate the asset or designed those aspects of the asset that predetermine how and for what purpose it will be used throughout the period of use (see paragraph 3.3.270). We believe it was the Board's intent to, in effect, create a bias toward a conclusion that the customer controls the use of the asset in close-call situations to mitigate structuring opportunities. [842-10-15-20]

3.3.310 We believe all facts and circumstances should be considered in determining who controls the use of an identified asset when the substantive decision-making rights about how and for what purpose the asset will be used are predetermined. For example, a contract may stipulate that the supplier operates the asset but the customer has the right to remove the supplier without cause at any time during the contract term and to hire someone else to

operate the asset. In this situation, we believe the customer controls the use of the asset.

3.3.320 This is supported by several examples included as illustrations in Subtopic 842-10. For example, in Example 6 Case A, the supplier operates the asset and the example adds that the customer is prohibited from hiring another operator or operating the asset itself – i.e. the customer does not have kick-out rights and accordingly the supplier controls the use of the asset. We believe the Board intended to highlight that if the customer did have the right to replace the supplier as the operator of the asset or had the right to operate the asset itself, the contract would be a lease because how and for what purpose the asset will be used is predetermined in the contract. [842-10-55-79 – 55-84]

3.3.330 While it appears that the Board attempted to mitigate structuring opportunities (e.g. by creating an apparent bias toward a conclusion that the customer controls the use of the asset in close-call situations), the guidance about when rights are predetermined may still provide some structuring opportunities because an entity might be able to avoid meeting the definition of a lease by carefully specifying what is predetermined versus what is not, and who makes what decisions. The following are examples.

- When the operation of the asset will be outsourced, the decision of which party will operate the asset could be predetermined in the contract.
- In many situations, the customer may not unilaterally design the asset – e.g. an investor might have expertise in renewable energy and play an active role in the design. In other cases, the design may involve no significant decisions because construction of the asset is straightforward such that the customer does not need to participate in the design of the asset.
- In other contracts, there may be, or the parties may be able to create, joint decision-making rights that neither party to the contract controls.



### Example 3.3.80

#### All relevant how and for what purpose decisions are predetermined – outsourcing arrangement

Assume the same facts as in Example 3.3.10, Scenario 2, except that the type, quantity and quality of the airbags to be produced are specified in the contract and neither Customer nor Supplier has the right to change any of those decisions absent a modification to the contract. Supplier has the right to make all of the operating decisions for the factory during the period of use. Customer has no right to hire another operator or to operate the factory itself.

Supplier and Customer analyze Customer's rights as follows to determine if the arrangement is a lease.

- The relevant decisions about how and for what purpose the factory will be used throughout the period of use (e.g. what and how much it will produce) are predetermined by the contract. Customer has no right to make or change the relevant decisions about how and for what purpose the factory

is used – e.g. Customer has no right to change what, whether, how much or when the factory produces.

- Because how and for what purpose the factory will be used is predetermined, Supplier and Customer consider whether Customer has other rights of use that extend beyond the receipt of output (i.e. airbags) from the factory. Customer does not have the right to operate the factory or to direct Supplier (or others) to operate it in a manner that Customer determines. Customer also did not design the factory or cause it to be designed in a way that predetermines throughout the period of use the relevant decisions about how and for what purpose the factory will be used.

As a result of this analysis, Supplier and Customer each conclude that the contract does not contain a lease.



### Example 3.3.90

#### **Right to direct the use of the identified asset is predetermined – storage warehouse**

Continuing Example 3.2.20, Customer enters into a five-year arrangement with Supplier for a climate-controlled storage warehouse to store its coffee beans. The storage warehouse is specified in the contract (storage warehouse 3C), Customer has exclusive use of the warehouse, and Supplier has no right to substitute it. Therefore, there is an identified asset.

The contract includes a list of items (coffee) to be stored, agreed on by Customer and Supplier, and a specific quantity of coffee that may be stored in the warehouse. Customer is not permitted to change the types or quantity of coffee stored or use the storage warehouse for any purpose other than storing coffee during the period of use. Customer has no right to operate (or direct others to operate) the storage warehouse and did not design it.

In this example, the contract does not contain a lease. Although Customer has the right to obtain substantially all of the economic benefits from use of the storage warehouse (because it has exclusive use of the warehouse), it does not have the right to direct its use. Customer does not have the right to direct how and for what purpose the storage warehouse is used; instead, it is predetermined in the contract. Customer also does not have the right to operate the warehouse and did not design it.



### Example 3.3.95

#### **Construction subcontractor arrangement (2) – perimeter fencing**

ABC Construction (Customer), the primary contractor on the construction of an office building, enters into a contract with XYZ Security (Supplier) to secure its city-center construction site. This includes Supplier erecting a fence around the construction site.

The fence allows Customer to restrict access to the construction site for safety and security reasons. Due to building regulations, the fence must remain throughout the construction period, which is expected to last three years. The dimension and grade of the fence is specified in the contract based on the size of the construction site and regulatory requirements. Supplier is responsible for the maintenance and zoning requirements for the fence. Customer controls who may access the construction site (e.g. its own personnel and those of its customer, and numerous subcontractors). At the end of the construction period, Supplier will remove the fence and related materials.

Customer and Supplier each analyze whether the contract contains a lease of the fence. The parties first conclude that the fence is an identified asset because it is a physically distinct item of property, plant or equipment, and once delivered to Customer's construction site, Supplier will not benefit economically from substituting equivalent fencing.

Customer and Supplier next consider whether Customer controls the use of the fence.

- They first determine that Customer has the right to obtain substantially all of the economic benefits from use of the fence. This is because there are no other parties that will benefit from its use during the construction of the building. The fence will solely protect Customer's construction site and the ability to fulfill that task is the fence's sole economic benefit from use.
- They then evaluate whether Customer or Supplier has the right to direct and change how and for what purpose the fence is used, or whether such decisions are predetermined.

Relevant how and for what purpose decisions	Considerations	Who controls the relevant decision or is it predetermined?
<b>Where</b>	Surrounding the city block on which the construction site resides, as specified in the contract. That area cannot be expanded or reduced during the construction period.	Predetermined
<b>What</b>	The fence will be used in the same manner throughout the construction period – i.e. to restrict access to the construction site for security and safety reasons. It cannot be used for any other purpose.	Predetermined
<b>When</b>	Throughout the construction period, as defined in the contract. The fence will remain erected at all times during the project and cannot be removed until a safety clearance is received at the end of the project.	Predetermined
<b>Whether / How much</b>	The fence is required by building regulations throughout the entire construction period.	Predetermined

Based on this analysis, all of the relevant decisions about how and for what purpose the fence will be used throughout the period of use are predetermined. Therefore, to determine if Customer has the right to direct the use of the fence, Customer and Supplier evaluate whether Customer

either (1) designed the fence or (2) has the right to operate (or direct others to operate) the fence.

- **Design.** Customer did not have input into the design of the fence – it is standard, non-specialized fencing.
- **Operations.** Once the fence is constructed, decisions about who is permitted to enter and exit the construction site during the construction period, as well as during what hours they may do so, are the relevant operational decisions. These decisions are controlled by Customer and cannot be overridden by Supplier.

Because Customer has the right to operate the fence in the manner it determines (and Supplier cannot override those operational decisions), Customer has the right to direct the use of the fence.

Because the fence is an identified asset and Customer controls the use of the fence, Customer is leasing the fence.



### Question 3.3.160

#### Evaluating the customer design criterion in renewable energy power purchase agreements

#### What does an entity consider when evaluating whether the customer designed a renewable energy power plant?

**Background:** As outlined in paragraph 3.3.270, when *all* of the relevant how and for what purpose decisions about use of the asset are predetermined – whether by design of the asset or by the terms of the contract – the customer is deemed to direct the asset's use if it either (1) operates the asset or (2) designed the asset (or specific aspects of the asset) in a way that predetermined those decisions (the 'design criterion').

In the case of renewable energy power purchase agreements (PPAs), all of the relevant how and for what purpose decisions about the plant's use – i.e. what the plant will produce (electricity); where it is located and will produce power; and when, whether and how much electricity it will produce – are often predetermined by the design of the plant. In addition, the plant owner typically operates and maintains the plant throughout the 'period of use' (see paragraph 3.1.130). Consequently, the question of whether the customer directs the use of the plant in these scenarios depends on the design criterion.

**Interpretive response:** Often in renewable energy PPAs, both the customer and the plant owner have some involvement in the plant's design. Therefore, the judgment to be made in assessing the design criterion is which party controlled – or most significantly influenced, if both parties were involved in a particular design decision – those design aspects that predetermined the relevant how and for what purpose decisions outlined in the background, which in effect predetermine the economic benefits to be derived from the plant's use.

The party (plant owner or customer) that controlled (or most significantly influenced) those design decisions will be the one deemed to have the right to

direct the use of the plant when the design criterion is determinative. Design decisions made by a third party (e.g. an engineering firm) should generally be attributed to the party (i.e. the plant owner or the customer) who engaged it.

Common design aspects of a renewable energy plant that affect the economic benefits that can be derived from its use include (not exhaustive):

- the specific location of the plant (or farm);
- the specific generating equipment (e.g. the specific turbines or solar panels) that will be used;
- the technical design of the plant (or farm); and
- site layout.

Which design aspects most significantly influence the economic benefits that can be derived from the plant's use will differ for different types of plants. That is, those design aspects usually are not the same for a solar farm as for a wind farm or a hydroelectric or geothermal plant.

Judgment is likely to be involved in evaluating (1) which design aspects are the most significant for a particular plant (or type of plant) and (2) which party controlled (or most significantly influenced) those design aspects. Judgment about which design aspects are the most significant to the economic benefits that can be derived from the plant during the period of use may require the involvement of engineers, scientists or other experts outside of an accounting or finance function.

When making judgments (1) and (2), it may be relevant to consider:

- whether the customer initiated the plant's construction – i.e. the plant subject to the PPA was (or is being) constructed to fulfill the customer's specific requirements; and
- if so, the extent to which certain design decisions are, in effect, predetermined by the customer's requirements (e.g. as to location, generating capacity).

If the plant is being constructed to meet specific customer requirements, this likely suggests there is, or will be, more customer involvement in design than if the plant is pre-existing or under construction by the supplier on spec. In contrast, if the plant is pre-existing or under construction by the supplier on spec, it is likely most significant design decisions were made by the supplier before PPA negotiations with the customer began.

If the customer's requirements substantively predetermine a key design decision, that decision generally should be attributed to the customer. For example, if the customer's power generation requirements can only be met by specific generating equipment (a certain type and model), that would typically suggest that the customer's decisions about those requirements were more significant to predetermining the economic benefits that can be derived from use of the plant than the supplier's actions of identifying and acquiring that generating equipment. This would be the case even if the customer did not know that there was only one generating equipment option that would meet its plant requirements.



## Comparison to legacy US GAAP

### New control concept differs from Topic 840

3.3.340 The concept of control over the use of the identified asset in Topic 842 is based on both a power element (the right to control the use of the identified asset) and a benefits element (the right to obtain substantially all of the economic benefits from use of that asset). While a lease could have existed under Topic 840 solely on the basis of the customer having the right to obtain substantially all of the output or other utility from an identified asset, the customer needs to have decision-making rights over the use of the asset for there to be a lease under Topic 842. The Board concluded that without the right to control the use of the identified asset, the customer has no more control over the asset than any customer purchasing goods or services from the supplier. [840-10-15-6]

3.3.350 Under Topic 840, the right to control the use of an asset was conveyed if: [840-10-15-6]

1. the purchaser had the ability to operate the asset in a manner it determined while obtaining or controlling more than a minor amount of the asset's output;
2. the purchaser had the ability or right to control physical access to the asset while obtaining or controlling more than a minor amount of the asset's output; or
3. there was only a remote possibility that one or more parties other than the purchaser would take more than a minor amount of the output and the price that the purchaser would pay for the output was neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output.

3.3.360 Under either criterion (2) or (3), control over the use of a specified asset did not require that the customer have the right to direct the use of the asset. The control concept in Topic 842 also differs from criterion (1) because the right to operate the asset is not considered relevant unless the substantive decisions about how and for what purpose the asset will be used are predetermined in the contract (or the operational decisions constitute relevant 'how and for what purpose' decisions – see Question 3.3.100). In addition, not only must the customer be able to direct the use of the asset, but the customer must also have the right to obtain substantially all (rather than only more than a minor amount) of the economic benefits from use of the asset throughout the period of use.

3.3.370 These changes to the concept of control mean that there will be some differences in terms of whether a contract is or contains a lease. Some contracts that were previously considered to be leases will no longer meet the definition of a lease and vice versa. For example:

- A lease may have existed under Topic 840, but will not exist under Topic 842, in arrangements where the customer receives substantially all of the output or utility of an identified asset, but does not control what, whether and/or how much output or utility the asset produces. Those leases under Topic 840 may also not be leases under Topic 842 if the

output or utility of the asset is not the only economic benefit available from use of the asset (see Question 3.3.40).

- In contrast, a lease may exist under Topic 842 that did not exist under Topic 840 where the customer has 'dispatch' rights – i.e. controls when, whether and/or how much output or utility an identified asset produces – but (1) does not operate or control physical access to the asset and (2) pays the supplier a variable amount per unit of output produced by the asset that is not equal to the market price for the output at the time of its delivery.

3.3.380 However, in general, we believe most arrangements that met the definition of a lease under Topic 840 will also meet the definition of a lease in Topic 842 and vice versa.



### Example 3.3.100

#### **Outsourcing arrangement that was a lease under Topic 840 but is not under Topic 842**

Customer enters into a 10-year agreement for Supplier to supply parts to Customer's manufacturing plant. Customer builds its facility adjacent to Supplier's manufacturing plant. Customer will make an equity investment in the entity formed by Supplier to own the facility but does not participate in the design of the facility.

The following additional facts are relevant.

- Customer and Supplier agree that the parts facility will produce constant-velocity (CV) joints for Customer.
- The initial capacity of the facility will be used to produce only CV joints and Customer will purchase all of the CV joints produced by the facility.
- The price paid by Customer will be determined based on Supplier's actual operating costs plus a profit margin.
- Supplier has the right to expand the facility in the future if it wishes to produce other parts (but does not expect to do so) and has the right to make all operating decisions for the facility.

#### **Topic 840**

Under Topic 840, the arrangement contained a lease because Customer was expected to obtain substantially all of the facility's output during the term of the arrangement for a price that was not fixed per unit of output or equal to the market price per unit of output at the time it was delivered.

#### **Topic 842**

Under Topic 842, the arrangement does not contain a lease. Customer does not have the right to direct the use of the facility throughout the 10-year period of use because it cannot direct how and for what purpose the facility is used.

Even though Supplier built the facility for the express purpose of supplying parts to Customer, Customer has no right to change how the facility is used or to change what, how much or when it produces. Because how and for what purpose the facility will be used is predetermined by the terms of the contract,

Supplier and Customer also consider whether the arrangement meets either of the criteria for directing the use of the asset when the how and for what purpose decisions are predetermined (see paragraph 3.3.270).

- Customer does not have the right to operate the facility or direct Supplier to operate it in a manner that Customer determines.
- Customer also did not design the facility (or specific aspects of the facility) in a way that predetermines how and for what purpose the facility will be used throughout the period of use.

Consequently, Customer is not leasing the facility.

Customer will need to separately evaluate whether to consolidate the entity that owns the facility. If it is required to consolidate the entity, the inventory acquisition accounting will be eliminated in Customer's consolidated financial statements.

There are a number of alternative fact patterns related to this example that would result in a conclusion that Customer has the right to direct the use of the facility, and therefore that the arrangement contains a lease. The following are some examples.

- If Customer had the right to change the parts produced by the facility throughout the period of use (e.g. to require that the facility produce axles rather than, or in addition to, CV joints), then Customer would have the right to direct the use of the facility. This is because it would be able to direct how and for what purpose the facility is used by virtue of being able to change what the facility produces.
- If Customer had the right to determine when and how many CV joints the facility produces throughout the period of use (i.e. Customer controlled how much output the facility produced, even if it could not change the nature of the output produced), then Customer would have the right to direct the use of the facility. This is because it would be able to direct how and for what purpose the facility is used by virtue of being able to effectively control whether, when and how much economic benefit is derived from use of the facility.

If Customer had designed the facility, or those specific aspects of the facility that predetermined how and for what purpose it would be used throughout the period of use, Customer would be deemed to have the right to direct the use of the facility.

# 4. Separating components of a contract

## Detailed contents

**New item added in this edition: \*\***

### How the standard works

#### 4.1 Step 1: Identify the separate lease components

- 4.1.1 Separating lease components
- 4.1.2 Additional considerations for land

##### **Observation**

Complexity of land separation analysis will vary

##### **Questions**

- 4.1.10 Accounting insignificance for land lease elements
- 4.1.20 Land and multi-tenant building

##### **Examples**

- 4.1.10 Leases of multiple underlying assets – separation criteria met
- 4.1.20 Leases of multiple underlying assets – separation criteria not met
- 4.1.30 Leases of multiple underlying assets – land element accounted for separately

##### **Comparison to legacy US GAAP**

#### 4.2 Step 2: Identify any non-lease components

- 4.2.1 Taxes and insurance

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- 4.2.05 Shipping, delivery, installation or similar activities
- 4.2.10 Common area maintenance
- 4.2.20 Assessing the number of CAM components
- 4.2.25 Capital replacements and repairs
- 4.2.30 Residual value guarantees
- 4.2.40 Property taxes and insurance – lessor or lessee costs

- 4.2.42 Identifying the primary beneficiary of lessee-obtained insurance on the underlying asset
- 4.2.45 Effect of lease classification on identifying lessor costs
- 4.2.50 Accounting for gross and net leases
- 4.2.60 Sales and other similar taxes
- 4.2.70 Refundable and nonrefundable VAT

### **Examples**

- 4.2.10 Differentiating lessor insurance costs from lessee insurance costs
- 4.2.20 Identifying components in gross and net leases
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- 4.2.40 Property taxes and insurance in a net lease – lessee reimburses lessor
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### **Comparison to legacy US GAAP**

#### **Comparison to legacy US GAAP**

### **4.3 Step 3: Measure the consideration in the contract**

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- 4.3.10 Measuring consideration in a contract with variable payments
- 4.3.20 Variable payments for CAM in a net lease
- 4.3.30 ‘Free lease’ granted to a supplier
- 4.3.40 Timing of measurement

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- 4.3.10 Measuring the consideration in the contract – variable payments
- 4.3.20 ‘Free lease’ granted to a supplier

### **Comparison to legacy US GAAP**

### **4.4 Step 4: Separate and allocate consideration between the lease and non-lease components**

- 4.4.1 Allocate the consideration in the contract
- 4.4.2 Allocate variable consideration in the contract – lessor

- 4.4.3 Variable payments not included in the consideration in the contract

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Predominant element

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Variable payments of lessor costs made directly to a third party recognized net by lessors

### **Questions**

- 4.4.05 Non-separation practical expedients – meaning of 'associated with'
- 4.4.10 Non-separation practical expedients for lessees and lessors not limited to insignificant non-lease components
- 4.4.11 Non-separation practical expedients elected by class of underlying asset
- 4.4.12 Lessor practical expedient – operating lease classification criterion
- 4.4.13 Lessor practical expedient – same pattern of transfer requirement
- 4.4.14 Lessor practical expedient – measure of progress toward satisfaction of a combined Topic 606 component
- 4.4.15 Lessor practical expedient – evaluating predominance
- 4.4.16 Lessor practical expedient – lease and services are not coterminous
- 4.4.17 Changes to the election of a practical expedient \*\*
- 4.4.20 [Not used]
- 4.4.30 Allocation on a relative stand-alone price basis
- 4.4.40 Different perspectives on observable stand-alone (selling) prices
- 4.4.50 Different estimation techniques
- 4.4.55 Stand-alone selling price estimation methods – residual approach (lessors)
- 4.4.56 Stand-alone selling price estimation methods – residual approach (lessees)
- 4.4.60 Allocating consideration when there are multiple lease and multiple non-lease components
- 4.4.65 Allocating consideration in related party leases
- 4.4.70 Stand-alone selling price for CAM provided by the lessor at a loss
- 4.4.80 Lessor accounting for a supply agreement that includes a 'free' lease of equipment

## Examples

- 4.4.05 Non-separation practical expedients – applying ‘associated with’
- 4.4.10 Allocating the consideration in the contract – observable inputs
- 4.4.20 Allocating the consideration in the contract – observable and estimated stand-alone (selling) prices (1)
- 4.4.25 Embedded supply agreement lease with minimum purchase quantities – lessee accounting
- 4.4.30 Allocating the consideration in the contract – observable and estimated stand-alone (selling) prices (2)
- 4.4.40 Percentage rent in a real estate lease
- 4.4.45 Supply agreement with no stated consideration for the lease
- 4.4.50 Variable lease payments not included in the consideration in the contract

## Comparison to legacy US GAAP

### Comparison to legacy US GAAP

## 4.5 Subsequent changes to the consideration in the contract

- 4.5.1 Lessee
- 4.5.2 Lessor

### Observation

Allocating subsequent changes to the consideration in the contract after a modification or remeasurement

### Question

- 4.5.10 Variable payments that do not depend on an index or rate and the consideration in the contract

## 4.6 Combining two or more contracts

### Observation

Combining two or more contracts

### Questions

- 4.6.10 ‘At or near the same time’
- 4.6.20 Different divisions or business units

### Example

- 4.6.10 Combination of contracts

## How the standard works

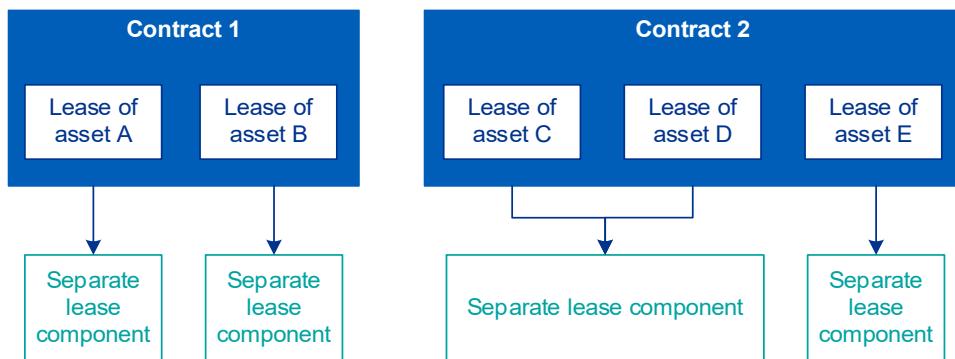
If a contract is, or contains, a lease, the entity follows these steps in accounting for the components of the contract:

- **Step 1:** Identify the separate lease components. In many cases there will be a single lease component, but in some cases, there will be multiple lease components.
- **Step 2:** Identify any non-lease components – e.g. a maintenance or operating service.
- **Step 3:** Measure the ‘consideration in the contract’. This calculation is different for the lessee versus the lessor.
- **Step 4:** Separate and allocate the consideration in the contract between the lease and non-lease components. This process and the requirements differ to some extent for the lessee and the lessor, but in both cases require the entity to maximize the use of observable data.

## 4.1

# Step 1: Identify the separate lease components

4.1.10 Lessees often contract with lessors for the right to use multiple underlying assets – i.e. the contract contains multiple leases. However, the unit of account in applying Topic 842 is not each lease in the contract – it is each ‘separate lease component’. A contract with multiple leases may contain many or only one separate lease component. The following diagram illustrates this principle. [842-10-15-28, 15-30]



4.1.20 On the basis that the requirements of Topic 842 for lessees and lessors apply to each separate lease component, an entity:

- assesses lease classification for the separate lease component – i.e. not for each of the individual leases that comprise that component (see section 6.2 for lessees and section 7.2 for lessors); and
- applies the recognition and measurement requirements of Topic 842 to each separate lease component (see section 6.3 for lessees, and sections 7.3 and 7.4 for lessors).

4.1.30 The guidance about what constitutes a separate lease component is the same for lessees and lessors.

## 4.1.1

### Separating lease components



#### Excerpt from ASC 842-10

##### 15 Scope and Scope Exceptions

###### General

> Separating Components of a Contract

**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).

## 55 Implementation Guidance and Illustrations

### General

- > Illustrations
  - > Illustrations of Allocating Consideration to Components of a Contract
  - • > 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:

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

*[The remainder of Example 11 Case A is not included in this section because it is not relevant to section 4.1 – it is included in full in section 4.4]*

••> Example 13—Lease of a Turbine Plant

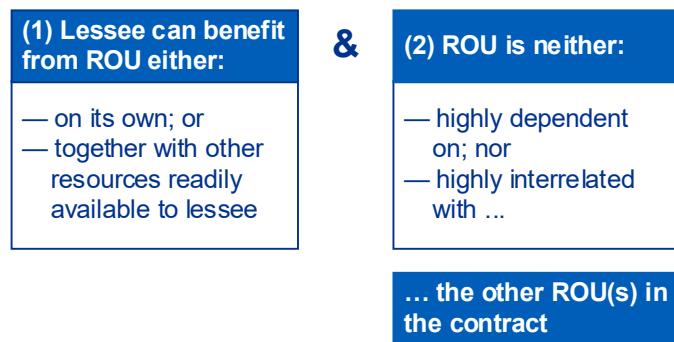
**55-146** Lessor leases a gas-fired turbine plant to Lessee for eight years so that Lessee can produce electricity for its customers. The plant consists of the turbine housed within a building together with the land on which the building sits. The building was designed specifically to house the turbine, 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.

4.1.40 A right to use an underlying asset (i.e. a lease), or a bundle of such rights, is a separate lease component if both of the criteria in paragraph 842-10-15-28 are met. [842-10-15-28]



4.1.50 In interpreting the first criterion in paragraph 842-10-15-28, 'readily available' resources are goods or services that are sold or leased separately by the lessor or other suppliers (e.g. office furniture), or that the lessee has already obtained from the lessor or from other transactions or events. And the fact that the lessor or other entities regularly lease an asset separately would indicate that a customer can benefit from the lease of that asset on its own or with other readily available resources. [842-10-15-28(a), 606-10-25-20]

4.1.60 In interpreting the second criterion in paragraph 842-10-15-28, a lease is highly dependent on or highly interrelated with another lease if each lease significantly affects the other. Topic 606 provides an example of when two or more goods or services are 'significantly affected by each other'. It states this would be the case when the entity would not be able to fulfill its promises to the customer by transferring each of the goods or services independently – i.e. fulfillment of each promise depends on the other. Example 4.1.20 illustrates how to apply this concept. [842-10-15-28(b), 606-10-25-21(c), ASU 2016-10.BC32]

4.1.70 The identification of separate lease components in a lease contract is similar to the identification of separate performance obligations in a revenue contract. This means that an entity applying the separate lease components guidance is, fundamentally, deciding whether the lessee has contracted for multiple leases (e.g. to use multiple pieces of similar office equipment) that the lessor can fulfill independently, or is instead leasing a combined item (e.g. a production facility or a data center comprising multiple underlying assets). This evaluation focuses primarily on the level of integration, interrelation and/or interdependence between the rights of use that are conveyed under the contract – i.e. whether those multiple rights to use underlying assets significantly affect each other. [IASU 2016-02.BC146]



### Example 4.1.10

#### Leases of multiple underlying assets – separation criteria met

Lessor LR leases a bulldozer, a truck and an excavator to Lessee LE to be used in LE's land development operations.

The equipment that LR leases is leased and sold separately by other suppliers and LR regularly leases each of these types of equipment separately. For

example, LR regularly leases a bulldozer to a customer without also leasing a truck or an excavator to the customer.

Despite the fact that LE is leasing all three machines for one purpose (i.e. to engage in land development), LR and LE each conclude that the lease of each underlying machine is a separate lease component for accounting purposes (i.e. there are three separate lease components).

This conclusion is based on the following:

- LE can benefit from each lease on its own, or together with other readily available resources; for example, LE could readily lease or purchase an alternative truck or excavator to use with the bulldozer; and
  - the leases are not highly dependent on, or highly interrelated with, each other. The ability of LR to fulfill each lease obligation (i.e. to make each underlying asset available for LE's use) is not affected by the other leases in the contract; LR could fulfill its lease obligation for any one of the three pieces of equipment even if the customer did not enter into a lease for either of the other two pieces of equipment. In addition, LE's ability to derive benefit from each lease is not significantly affected by its decision to lease or not lease the other equipment from LR.
- 

## 4.1.2 Additional considerations for land

4.1.80 For leases that include a land element (e.g. a lease of land and a building, or land and integral equipment), the right to use the land is considered a separate lease component unless the accounting effect of separately accounting for the land element would be 'insignificant'. [842-10-15-29]

4.1.90 Topic 842 provides the following examples of circumstances in which the accounting effect of accounting for the land element separately would be insignificant: [842-10-15-29]

- separating the land element would have no effect on lease classification; for example, it would not affect whether the land or the related building (or integral equipment) is classified as a finance or an operating lease; or
- the amount that would be recognized for the land lease component is insignificant.

4.1.100 Those examples are not exhaustive, and Topic 842 does not define insignificant. Consequently, determining whether the effect of accounting for a land lease element as a separate lease component would be insignificant may require significant judgment in some cases. [IASU 2016-02.BC147]



### Question 4.1.10

#### Accounting insignificance for land lease elements

##### How should entities evaluate the concept of insignificance when deciding whether to separate a land lease element?

**Interpretive response:** We believe the Board intended that if the lease classification of a *combined* (e.g. land plus building or land plus integral equipment) lease component would not differ from that of the two lease components evaluated separately, an entity should not be required to account for the lease components separately. The Board considered separation of building (or integral equipment) and land lease components in situations where there would be no effect on classification as inconsequential from an accounting perspective.

If there is a classification difference that would result from separation, it would affect the following for lessees: timing of lease cost recognition; amounts recognized on the balance sheet after lease commencement; presentation in the income statement, balance sheet and statement of cash flows; and disclosures. The effects for lessors would be similar.

The second example provided in paragraph 842-10-15-29 appears to suggest it was the Board's intent to ignore such effects if they would be 'insignificant'. For example, if either component was quantitatively insignificant, the effect on the contract of accounting for that component using the 'wrong' classification may also be insignificant.

Consistent with many other aspects of the guidance in Topic 842, we believe the concept of insignificance was considered by the Board similarly to how that term was considered in Topic 606. Consequently, we believe insignificance with respect to the amount that would be recognized is principally a quantitative evaluation that occurs in the context of a single contract. That is, if the accounting effect of non-separation is insignificant to the contract, an entity does not further consider whether unrecognized separate land lease components would be significant at a portfolio or financial statement level.

[606-10-25-16A, ASU 2016-10.BC12, ASU 2014-09.BC234]



### Example 4.1.20

#### Leases of multiple underlying assets – separation criteria not met

Lessor LR leases a production facility to Lessee LE for LE to produce its widgets for five years.

The production facility includes the building, the land the building is on, and several pieces of manufacturing equipment that are installed within the building. The building was designed to house manufacturing equipment, and it would be difficult and costly to remove the equipment from the facility. The remaining economic lives of the building and the equipment are substantially longer than the lease term.

### Identify the separate lease component(s)

LE could lease or purchase each of the underlying assets independently; for example, it could acquire a piece of equipment to put into the production line or relocate the equipment to a substantially equivalent vacant building. Therefore, LE can benefit from each lease on its own or together with other readily available resources.

However, the leases in this contract are highly interdependent and highly interrelated. The nature of this arrangement is the lease of an in-place production facility with which LE can produce its widgets. The land, the building and the installed equipment are, in effect, inputs to the combined item that LE contracted to lease.

The multiple leases significantly affect each other because, absent significant time and expenditure, LR would not be able to fulfill its obligation to lease the land, the building or any of the pieces of installed equipment without also conveying a right to use those other assets. For example, to grant a lease of the land only, LR would have to uninstall and relocate the manufacturing equipment and demolish the building.

Consequently, there is only a single lease component.

### Additional consideration of the land element

The above conclusion notwithstanding, because the contract contains a lease of land, LR and LE also need to consider the guidance specific to leases that include a land element.

Applying the guidance in paragraphs 4.1.80 – 4.1.100, LR and LE each conclude that the accounting effect of separately accounting for the land lease would be insignificant, and therefore they do not account for the land lease as a separate lease component. This is because, given the five-year lease term (which is the same for all of the elements) and the lease payments, each lease (land, building, equipment), if evaluated independently, would be an operating lease. Therefore, the accounting effect of separating the land element from the otherwise single lease component would be insignificant.



### Example 4.1.30

#### Leases of multiple underlying assets – land element accounted for separately

Lessor LR leases an entire, non-specialized building to Lessee LE for 25 years with no renewal or termination options; in addition to the explicit lease of the building, there is an implied lease of the underlying land for the same period (see paragraph 4.1.130). There are no non-lease components of the contract.

In addition, the following facts are relevant (LE and LR).

Annual payments (in advance):	\$850,000
Residual value guarantees:	None
Purchase options or title transfer provisions:	None
Remaining economic life of the building at lease commencement:	30 years

	Land	Building	Land and building
Fair value:	\$1,200,000	\$10,800,000	\$12,000,000
Estimated future residual value:	\$1,200,000	\$ 2,800,000	\$ 4,000,000
LE's incremental borrowing rate (implicit rate cannot be readily determined): <sup>1</sup>	7.5%	8%	8%
LR's implicit rate for the lease:	7.61%	6.21%	6.38%

Note:

1. The incremental borrowing rate is the rate of interest that LE 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. As the amount of lease payments related to the land and building are different, LE's incremental borrowing rate may also be different.

Total consideration for the term of the contract is \$21,250,000 (\$850,000 × 25 years). LR and LE each conclude that, based on the stand-alone (selling) prices of each lease, 90% of the consideration (\$19,125,000) should be allocated to the building lease and 10% (\$2,125,000) to the land lease.

### LE's incremental borrowing rate

LE does not know LR's estimated residual value of the land, building or land and building or LR's deferred initial direct costs. Without this information, LE cannot determine the rate implicit in the lease (see Question 5.6.20). Therefore, LE will use its incremental borrowing rate as the discount rate for the lease. In determining the incremental borrowing rate, LE considers the rate of interest it would pay on a secured borrowing in an amount equal to the lease payments for the land (\$2,125,000), the building (\$19,125,000), and the land and building (\$21,250,000) under similar terms (e.g. over 25 years).

### LR's implicit rate

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

For this example, assume there are no residual value guarantees, deferred initial direct costs or investment tax credit. LR calculates the rate implicit in the lease as follows.

Component	Lease payments	Estimated residual value	Fair value	Rate implicit in the lease
Land	\$ 2,125,000	\$1,200,000	\$ 1,200,000	7.61%
Building	19,125,000	2,800,000	10,800,000	6.21%
Land and building	21,250,000	4,000,000	12,000,000	6.38%

The lease term (25 years) is for a major part of the building's remaining economic life (30 years). Therefore, LE and LR would classify the building lease as a finance lease and sales-type lease, respectively.

### Classification

LE and LR each evaluate the present value of the lease payments for purposes of determining the classification of the land lease. None of the other finance/sales-type lease classification criteria are met for the land lease (see sections 6.2 and 7.2 for lessee and lessor lease classification criteria, respectively).

- **LE.** Present value of the lease payments allocable to the land lease (fixed at \$85,000 per year, paid in advance, for 25 years) discounted at LE's incremental borrowing rate of 7.5% is \$1,018,552, which is 85% of the land's fair value. LE concludes that the land lease does not meet the present value test (see Question 6.2.20) and will be classified as an operating lease.
- **LR.** Present value of the lease payments allocable to the land lease (fixed at \$85,000 per year, paid in advance, for 25 years) discounted at the rate implicit in the lease of 7.61% is \$1,009,832, which is 84% of the land's fair value. LE concludes that the land does not meet the present value test (see Question 6.2.20) and will be classified as an operating lease.

Therefore, LR and LE each conclude that the accounting effect of not separately accounting for the land lease would be more than insignificant because, if separate lease components:

- the building lease and the land lease would be classified differently – as a finance/sales-type lease and an operating lease, respectively; and
- the amount that would be recognized for the land lease component separately is not insignificant such that the different classifications would have an only insignificant accounting effect.



### Observation

#### Complexity of land separation analysis will vary

4.1.110 If a lease of real estate includes a land lease component, Topic 842 requires that component to be accounted for separately unless the accounting effect of doing so would be insignificant. Consequently, in a lease of real estate it is necessary to determine:

- whether the lessee obtains a right to use the land; and
- if so, whether the accounting for that right of use is more-than-insignificantly different on a stand-alone basis from what it would be if combined with the other lease component(s) in the arrangement.

4.1.120 Determining whether a lease of real estate includes a right to use the underlying land includes determining:

- whether the land represents an identified asset; and
- if so, whether the lessee has the right to control its use.

4.1.130 Topic 842 does not distinguish between types of real estate leases (e.g. gross leases versus net leases, or building leases versus leases of integral equipment) or the duration of the lease term in establishing whether a land lease component should be accounted for separately. However, the evaluation will frequently differ for leases of single-tenant properties versus leases of space in multi-tenant properties. While leases of single-tenant properties will generally include a lease of the underlying land, frequently leases of space in multi-tenant properties will *not* include a lease of the underlying land. Specific considerations relevant to leases of space (e.g. office or retail space) in multi-tenant properties are discussed in Question 4.1.20.

4.1.140 If it is determined that there is a land lease component, it may be considerably less complex to determine whether that land lease component should be accounted for separately from the building (or integral equipment) lease component than what is illustrated in Example 4.1.30. This will frequently be the case in shorter-term lease scenarios.

4.1.150 In shorter-term real estate lease scenarios (e.g. 3, 5 or even 10 years), it will typically be the case that both the given space and the implied land component will be determined to be operating leases with relatively little effort. For example, entities may be able to reach this conclusion without having to undertake much of the effort illustrated in Example 4.1.30 because it will be clear that any rational allocation of the lease payments, even on an undiscounted basis, will not equal or exceed substantially all of the fair value of either the building or the land. And as described in Question 4.1.10, if there is no effect on lease classification, the building component and the land component should not be separately accounted for.



## Question 4.1.20

### Land and multi-tenant building

#### **Does a lease of space in a multi-tenant building include a lease of the underlying land that must be evaluated for separation?**

**Interpretive response:** It depends. In many multi-tenant lease arrangements – e.g. a lease of retail space in a shopping mall or office space in a multi-tenant building – we do not believe there is a lease of the underlying land. Therefore, neither the lessee nor the lessor needs to evaluate the land separation criteria in paragraph 4.1.90.

In general, we believe that in a typical multi-tenant lease scenario, the lessee does not have a right to control the use of any physically distinct portion of the land underlying the multi-tenant building. Rather, all of the tenants enjoy a shared benefit from all of the underlying land – i.e. the underlying land supports the entire building; there is no physically distinct portion of the land specifically supporting the lessee's leased space in the building.

Further, if it is concluded that the entire underlying land is an identified asset, no single lessee in the multi-tenant building is likely to have control over its use. No single lessee would be deemed to have either: [\[IASU 2016-02.BC133\]](#)

- the right to obtain substantially all of the economic benefits from use of the land; or
- the right to direct the use of the land – i.e. change how and for what purpose the land is used, or affect how the land is operated if the relevant how and for what purpose decisions for the land are viewed as predetermined.

In contrast, a land lease component may exist if the lessee is leasing substantially all of the building, or substantially all of the capacity of a piece of integral equipment (e.g. a cellular tower). In that case, the entirety of the underlying land would likely be considered a single, identified asset and the lessee may have the right to control its use just as it would if it were leasing the entire building (or piece of integral equipment). If so, the lessee is required to account for the land lease component separately unless the criteria in paragraph 4.1.90 are met.



## Comparison to legacy US GAAP

### **Separating land lease components**

4.1.160 Topic 840 required separate accounting for the land and building elements of a lease when the fair value of the land was 25 percent or more of the total fair value of the property at lease inception. [\[840-10-25-38\(b\)\(2\)\]](#)

4.1.170 The method under Topic 842 by which lease payments are allocated between the land and building represents a change from Topic 840, which required lease payments equal to the product of the fair value of the land multiplied by the lessee's incremental borrowing rate to be allocated to the land element and the residual portion of the lease payments to be allocated to the building element. [\[840-10-25-38\(b\)\(2\)\]](#)

4.1.180 This difference could change the pattern of expense or income for leases of land and buildings in some cases. However, this potential outcome is mitigated by the relatively high proportion of situations in which the lease classification tests (see sections 6.2 (lessees) and 7.2 (lessors)) likely will result in operating lease classification for both the land and the building lease elements if they were accounted for separately.

### **Separating other lease components**

4.1.190 Topic 840 required the equipment element(s) of a lease of both real estate and equipment to be accounted for separately from the real estate element(s). However, lessees and lessors generally accounted for leases of multiple underlying assets of the same nature (i.e. buildings or equipment):

- in the aggregate if the separate leased assets were functionally interdependent – e.g. a mainframe computer system, associated terminals, servers, and other peripheral and output devices may be considered functionally interdependent; and

- separately if the separate leased assets were functionally independent – e.g. a manufacturing facility and an office building typically would be considered functionally independent.

## 4.2 Step 2: Identify any non-lease components



### Excerpt from ASC 842-10

#### **15 Scope and Scope Exceptions**

##### **General**

> Separating Components of a Contract

**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 15-42C 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.

**15-31** An entity shall account for each separate lease component separately from the nonlease components of the contract (that is, unless a lessee makes the accounting policy election described in paragraph 842-10-15-37 or unless a lessor makes the accounting policy election in accordance with paragraph 842-10-15-42A). Nonlease components are not within the scope of this Topic and shall be accounted for in accordance with other Topics.

**15-32** See Examples 11 through 14 (paragraphs 842-10-55-131 through 55-158) for illustrations of the requirements for allocating consideration to components of a contract.

**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.

**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).

## 55 Implementation Guidance and Illustrations

### General

> Illustrations

- > Illustrations of Allocating Consideration to Components of a Contract
- • > 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:

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

**55-134** In accordance with paragraph 842-10-15-31, Lessee and Lessor will account for the nonlease maintenance services components separate from the three separate lease components (unless Lessee elects the practical expedient—see Case B [paragraphs 842-10-55-138 through 55-140]). In accordance with the identifying performance obligations guidance in paragraphs 606-10-25-19 through 25-22, Lessor further concludes that its maintenance services for each piece of leased equipment are distinct and

therefore separate performance obligations, resulting in the conclusion that there are three separate lease components and three separate nonlease components (that is, three maintenance service performance obligations).

*[The remainder of Example 11 Case A is not included in this section because it is not relevant – it is included in full in section 4.4]*

- > 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.

4.2.10 A contract might contain non-lease components in addition to lease components – e.g. an arrangement to lease a machine with the lessor responsible for machine maintenance or for operating the machine, or to lease office space with the lessor responsible for common area maintenance (CAM). In these examples, the machine maintenance, the operation services and CAM are non-lease components of the contract. The consideration in the contract, determined in Step 3 (see section 4.3), is allocated between the lease and non-lease components in Step 4 (see section 4.4). [842-10-15-31]

4.2.20 Not every element of a contract that contains a lease is necessarily a 'component'. While it may be intuitive to assume that any activity or payment that is not a lease component or an explicit 'lease payment' must be a non-lease component, this is not how Topic 842 works. Instead, some elements of a contract may not be components at all because they do not transfer a good or service to the lessee. [842-10-15-30]



4.2.30 Examples of activities (or costs of the lessor) that do not transfer a good or service to the lessee include a lessee's reimbursement or payment (to a third party) of the lessor's property taxes and insurance. A lessee's payment of such amounts is discussed in section 4.2.1, which highlights applying Step 3 (measuring the consideration in the contract) and Step 4 (allocating the consideration in the contract) when certain elements of the contract are not components. [842-10-15-30]

4.2.40 The guidance in Topic 842 on separating lease from non-lease components of a contract applies only once an entity has determined that a contract is or contains one or more leases (see chapter 3). No aspect of the separation or allocation guidance for lease and non-lease components affects the conclusion already reached that the contract is or contains one or more leases. For example, a determination that the contract involves a very significant service (i.e. non-lease) component, upon which effective use of the underlying asset depends, does not change the conclusion that there is a lease. [842-10-15-28, ASU 2016-02.BC142]



### Observation

#### **Components in Topic 842 equivalent to promised goods or services in Topic 606**

4.2.50 The guidance on activities or costs that do not transfer a good or service to the lessee (e.g. payments of the lessor's property tax and insurance) is intended to be consistent with the guidance in Topic 606 relating to set-up or other activities that do not transfer a good or service to the customer (see chapter 4 of KPMG Handbook, [Revenue recognition](#)). In both cases, no consideration is allocated to such activities; consideration is only allocated to promised goods or services. [IASU 2016-02.BC159]

4.2.60 The Board concluded that defining components as only those items that transfer a good or service to the lessee provides a clearer way in which to identify the components of a contract that is likely to be operable for both lessees and lessors. It also prevents entities from structuring how payments are written into a contract to avoid their classification as lease payments, and therefore their inclusion in the lessee's lease liability. [ASU 2016-02.BC160]



### Question 4.2.05

#### **Shipping, delivery, installation or similar activities**

**Are shipment, delivery, installation or similar activities undertaken by the lessor related to the underlying asset that occur before lease commencement non-lease components?**

**Interpretive response:** No. Shipping, delivery, installation or similar activities related to the underlying asset that the lessor undertakes before lease commencement (even if performance thereof is a condition of the lease

contract) are not services to the lessee, and therefore are not non-lease components of the contract. For example, if the lease contract stipulates that the lessor will deliver and install the underlying asset at the lessee's premises or other lessee-designated location and that it will occur before lease commencement, those delivery and installation activities are not non-lease components of the contract.

In contrast, if such activities are performed *after* lease commencement, they generally will be considered non-lease services provided to the lessee. In that case, they will be accounted for consistent with the accounting for any other non-lease component of a contract.

This interpretive response generally is not affected by whether the lessor performs the activities itself or engages a third party to do so.

Section 5.1 provides guidance on determining the commencement date for a lease. Question 5.1.10 addresses lessee and lessor accounting for lessee payments made, and lessor costs incurred, for the activities discussed in this question.



#### Question 4.2.10

##### **Common area maintenance**

#### **Is CAM a non-lease component under Topic 842?**

**Background:** CAM generally includes maintaining the common areas (e.g. restrooms, food court, lobby) and the grounds of a multi-tenant building. Typical maintenance activities include landscaping, janitorial services, snow removal and repairs.

**Interpretive response:** Yes. CAM transfers a good or service to the lessee other than the right to use the underlying asset, and therefore it is a non-lease component of the contract. As a result, a portion of the consideration in the contract is allocated to CAM (non-lease component). [842-10-55-144 – 55-145]



#### Question 4.2.20

##### **Assessing the number of CAM components**

#### **Is CAM a single non-lease component or does CAM encompass multiple non-lease components?**

**Interpretive response:** Whether CAM is a single non-lease component or multiple non-lease components is assessed based on the performance obligations guidance in Topic 606 – Step 2 of the Topic 606 revenue model (see chapter 4 of KPMG Handbook, [Revenue recognition](#)).

We believe the nature of CAM is such that it will frequently comprise only a single performance obligation under Topic 606; therefore, it will be a single non-

lease component when allocating the consideration in the contract under Topic 842.

In many lease arrangements, CAM is substantially similar to the hotel management services in Example 12A in Topic 606 and the IT outsourcing services example discussed by the TRG. In fulfilling its promise to provide CAM, the nature of which is to maintain the common areas of the multi-tenant property, the lessor performs a variety of underlying activities, and those activities vary in terms of timing and quantity. For example, at lease commencement, it is not known how much snow the lessor will have to clear from the parking lot during the winters, the extent of landscaping that will be required during the spring and summer months, when or how often minor repairs will be needed, or when unexpected janitorial needs will arise; but regardless, the lessor commits to undertake those activities as needed to fulfill its overall promise to the lessee to provide it space in a building with maintained common areas. [606-10-55-157B – 55-157E, TRG 07-15.39]

The preceding notwithstanding, the characterization of an activity as part of CAM does not necessarily mean it is not a separate non-lease component – i.e. separate from the other activities that are part of CAM. There is no single or standard definition of CAM; therefore, lessors may characterize items that are not part of fulfilling the promise to the lessee to maintain the common areas of the building as part of CAM. This may include billing for those items together with CAM or as part of a single CAM billing. Entities will need to evaluate what promised lessor activities are truly part of fulfilling CAM, and separately account for those that provide a different or incremental benefit to the lessee *beyond* maintaining the common areas of the property.

As an example, lessors will frequently provide the utilities needed by the lessee (e.g. heat, water, electricity). In some cases, the provision of utilities is characterized as part of, or billed together with, CAM. Despite its characterization in the contract or how it is billed, the provision of utilities to the lessee is generally a separate non-lease component because the provision of utilities to the lessee is not an underlying activity to maintain the common areas of the property and is distinct from the CAM.

Another example of an item that may not be appropriately characterized as CAM is the provision of non-routine or ‘major’ maintenance. Facts and circumstances will need to be considered, but the performance of non-routine or major maintenance should not be presumed to be part of a single CAM non-lease component.



### Question 4.2.25

#### **Capital replacements and repairs**

#### **Is a lessor's replacement or repair of the asset's essential structure a non-lease component?**

**Background:** A lessor frequently has the contractual right to pass through costs of capital replacements or repairs to its tenants. For example, if a lessor installs

a new roof on its property (i.e. part of its essential structure), the tenants may be required to reimburse the lessor for those costs. A common reimbursement structure is for tenants to reimburse the lessor consistent with the useful life of the replacement/repair and consistent with the lessee's proportionate right to use the property.

In determining how to account for those lessee reimbursements, a key first question is whether the capital replacement/repair is a non-lease component of the contract.

**Interpretive response:** It depends on whether the capital replacement/repair is a promise to the lessee. This would be the case if the particular replacement/repair is either:

- promised in the lease contract; or
- an activity necessary to fulfill another lessor performance obligation (e.g. CAM).

If a particular capital replacement or repair is a promise to the lessee, the lessor will need to determine whether that particular replacement/repair is a separate performance obligation under Topic 606, or instead is part of another performance obligation such as CAM – i.e. one of many fulfillment activities necessary to satisfy that performance obligation.

Using CAM as an example, *necessary* repairs to the roof of the property are part of the CAM performance obligation. Maintaining the roof is a fulfillment activity of the CAM; it is not an additional performance obligation that is separate from other CAM fulfillment activities such as cleaning/maintaining the customer restrooms, food court, parking lot, and/or parking garage.

In contrast, a capital replacement or repair that is not a promise to the lessee (as described above) is similar to property tax or insurance costs that a lessor incurs as the owner of the property. Typically, this replacement or repair will benefit the lessor's asset for many years past existing tenants' lease terms at the time of the replacement or repair. Because this action does not fulfill a promise to any particular lessee, a requirement for the lessee to reimburse the lessor for the replacement/repair is substantively the same as a requirement for the lessee to reimburse the lessor for its property tax or insurance costs.

Questions 6.6.50 and 7.4.20 address lessee and lessor accounting, respectively, for lessee reimbursements of capital replacements and repairs that are not promises to the applicable lessee.



### Question 4.2.30

#### Residual value guarantees

## Are residual value guarantees a component (lease or non-lease) of a contract that includes a lease?

**Interpretive response:** No. Residual value guarantees are not components of a contract that is or contains a lease. Section 5.4.6 discusses the accounting for residual value guarantees under Topic 842.



## Comparison to legacy US GAAP

### Maintenance, including CAM

4.2.70 Topic 840 excluded 'substantial services' from its scope. In general, anything that was considered a substantial service under Topic 840 is a non-lease component of a contract under Topic 842. [840-10-15-8, 15-19]

4.2.80 However, substantial services excluded 'executory costs', which included maintenance of the underlying asset. Therefore, maintenance of the underlying asset, including CAM in real estate leases, was considered part of the lease element under Topic 840. Consequently, lessee payments attributable to maintenance of the underlying asset that were fixed were part of the 'minimum lease payments' for the lease (but excluded from that amount for purposes of lease classification and measurement) and, potentially, part of the minimum rental payments (see Questions 13A.3.10 and 13B.3.10). [840-10-25-1(d), 25-5(b), 25-6]

4.2.90 In contrast, under Topic 842, maintenance (including CAM) is a non-lease component, and the portion of the 'consideration in the contract' (see section 4.3) allocable to maintenance is excluded from the 'lease payments'.

4.2.100 Consequently, the lease payments under Topic 842 will be less than the 'minimum lease payments' and may be less than the 'minimum rental payments', would have been for the same lease under Topic 840 when there are fixed payments for maintenance, including CAM, required by the contract (ignoring any other potential differences between these defined terms).

### 4.2.1 Taxes and insurance

4.2.110 This section explores the accounting for various tax and insurance payments made by a lessee in connection with a lease, including considerations relevant to determining whether the taxes and insurance are costs of the lessee (lessee costs) or of the lessor (lessor costs). This section also explores the different outcomes of a gross lease versus a net lease.

- In a gross lease, lessee payments of taxes and insurance are fixed as part of the rental payments specified in the contract.
- In a net lease, the lessee makes variable payments, either to the lessor or to a third party, for items like property taxes and insurance.

### Property taxes and insurance

4.2.120 As discussed in paragraphs 4.2.20 – 4.2.30, a lessee's reimbursement or payment of the lessor's property taxes and insurance is an example of an activity (or costs of the lessor) that does *not* transfer a good or service to the lessee. [842-10-15-30]

4.2.130 In a gross lease (see paragraph 4.2.110 and Example 4.2.20), the lessee's payments are always part of the 'consideration in the contract', which means they are:

- allocated to the separate lease and non-lease components of the contract in Step 4 (see section 4.4); and
- affect the measurement of (1) lease assets and lease liabilities, and (2) lease cost (lessee) or lease income (lessor).

4.2.140 In a net lease (see paragraph 4.2.110 and Example 4.2.20), the lessee's payments of property taxes are not part of the consideration in the contract for the lessee because they are variable. For lessors, they are not part of the consideration in the contract because they are variable *and* because they do not relate specifically to a non-lease component (see paragraph 4.3.50). Accounting for the payments depends on whether the property taxes and insurance are lessee or lessor costs (see Questions 4.2.40, 4.2.42 and 4.2.45).

4.2.150 If the property taxes and insurance are lessee costs, neither the costs nor the lessee's variable payments thereof are part of the entity's lease accounting.

- The **lessee** accounts for the costs in the same way as any other period costs.
- The **lessor** recognizes neither the cost nor the lessee's payment thereof.

4.2.160 If the property taxes and insurance are lessor costs, the following applies.

- The **lessee** accounts for variable payments of those costs in the same way as any other variable payments (see section 4.4.3).
- The **lessor** recognizes the costs separately from the lessee's variable payments thereof – i.e. on a gross basis (see 'Gross vs. net considerations' in section 7.3.2).



#### Question 4.2.40

#### **Property taxes and insurance – lessor or lessee costs**

### **Are property tax or insurance payments required by a lease contract costs of the lessor or executory costs of the lessee?**

#### **Interpretive response:**

#### **Lessee accounting**

Example 12 in Subtopic 842-10 illustrates two important considerations for a lessee in determining whether a payment is for the lessor's costs. Example 12 concludes that: [842-10-55-141 – 55-145]

- the property taxes being reimbursed to the lessor are the lessor's costs because they would be owed by the lessor regardless of whether it leased the building and who the lessee is; and

- the building insurance is a lessor cost because the lessor is the 'named insured' on the building insurance policy, and therefore the policy principally benefits the lessor by protecting the lessor's investment in the building.

Therefore, we believe a lessee should consider any lessee payment that is required by the contract to be a reimbursement or payment of a lessor cost if the payment is for a cost the lessor would have regardless of the lease (e.g. most property taxes) or if the lessor is the primary beneficiary of the payment, such as in the case of the building insurance in Example 12. Question 4.2.42 discusses further when we believe the lessor is the primary beneficiary of a lessee-obtained insurance policy that covers the underlying asset.

Consistent with the guidance in paragraph 842-10-15-30(b), it does not matter whether the lessee pays those costs directly (e.g. to a taxing authority or insurer) or through a reimbursement to the lessor (see section 7.3.2). However, as noted elsewhere in this section, the accounting may differ significantly depending on whether the payment of those amounts, regardless of the party to whom the payment is made, is fixed or variable.

Payments related to insurance may benefit both the lessee and the lessor. An example is insurance that principally protects the lessor's investment in the underlying asset, but also protects the lessee from having to replace or repair the underlying asset using its own funds. The lessee's insurance may also reimburse the lessee for use of an alternative asset while the underlying asset is being repaired. In such cases, we do not believe an entity should split the policy payments between an amount that reflects the benefit to the lessor and an amount that reflects the benefit to the lessee.

However, in contrast, an insurance policy might include multiple distinct insurance services that could be purchased separately, some of which principally benefit the lessee and others that principally benefit the lessor. In that case, we believe an entity should bifurcate the policy between the distinct insurance services.

The bifurcation should be based on stand-alone (selling) prices in those instances. As an example, a lessee may be required to obtain a building insurance policy that names the lessor as the insured beneficiary for any loss to the building, but also obtains renters' insurance from that same insurance company (protecting its contents). In this example, it would be appropriate to bifurcate the premium for the renters' insurance from the building insurance because those two policies can, and frequently are, purchased separately. If the policy amounts for each type of insurance do not reasonably reflect the stand-alone prices for those policies, the bifurcation should reflect those stand-alone prices rather than the stated premiums in the contract.

### **Lessor accounting**

Before the issuance of ASU 2018-20 in December 2018, a lessor applied the same considerations as a lessee to determine whether a variable payment was for a lessor cost or lessee cost. Sections 13A.4.3 (effective date transition method) and 13B.4.3 (comparative transition method) discuss the effective date and transition provisions for ASU 2018-20.

After the adoption of ASU 2018-20, for lessors only, property taxes and insurance on the underlying asset are accounted for as:

- **lessee costs** if the lessee remits the tax or pays the insurance premium directly to the relevant third party – e.g. the taxing authority or insurer.
- **lessor costs** if the lessor remits the tax or pays the insurance premium to the relevant third party and receives reimbursement from the lessee.

No additional analysis is undertaken by a lessor, such as that required of lessees, to determine whether the property taxes or insurance are lessee or lessor costs. In other words, it does not matter for lessors whether they are the primary obligor for a property tax or the primary beneficiary of insurance on the underlying asset; whether the property tax or insurance is a lessee or a lessor cost is determined solely by which party (lessee or lessor) pays the relevant taxing authority or insurer.



#### Question 4.2.42

#### **Identifying the primary beneficiary of lessee-obtained insurance on the underlying asset**

#### **When is the lessor the ‘primary beneficiary’ of insurance on the underlying asset obtained and paid for by the lessee?**

**Background:** Lease contracts frequently require the lessee to obtain and maintain insurance on the underlying asset throughout the lease term.

Question 4.2.40 explains that costs of insurance on the underlying asset that *primarily* benefit the lessor are accounted for as lessor costs, rather than executory costs of the lessee.

**Interpretive response:** Notwithstanding that the lessee also benefits from the insurance in many cases, an insurance policy on the underlying asset may *primarily* benefit the lessor even when the lessee obtains the required policy in its own name and is responsible for the payment of the policy premium.

Topic 842 does not address when the lessor is the primary beneficiary of the insurance in that scenario.

In the absence of specific guidance, we believe either of the following approaches is acceptable. Approach 2 will result in a conclusion that the lessor is the primary beneficiary of lessee-obtained insurance in more cases than Approach 1.

#### **Approach 1: Proceeds must be used for lessor’s benefit**

The lessor is the primary beneficiary when:

- a. the insurance policy covering the underlying asset is obtained by the lessee as a requirement of the lease contract; and
- b. the terms of the policy, the lease contract or another contractual arrangement ensure that the insurance proceeds from a claim must be:
  - remitted to the lessor at the lessor’s election; or
  - used to repair or replace the underlying asset.

For example, the lessor would be the primary beneficiary of the insurance if the insurance is a requirement of the lease contract and the lessor is entitled to either:

- receive the funds paid by the insurer on any claim pertaining to the asset; or
- approve the release of the funds paid on any claim pertaining to the asset – e.g. the lessor may have the right to endorse an insurance claim check for the lessee to receive the funds, which it may only do if it is assured the lessee will use the funds to repair or replace the underlying asset.

When criterion (b) is met, the insurance required by the lease contract serves as a guarantee *to the lessor* that its investment in the underlying asset is protected regardless of the lessee's actions in the event of damage to, or destruction of, the underlying asset. And in that case, the insurance is of primary benefit to the lessor.

When that is not the case, the insurance does not guarantee that the lessee will repair or replace the lessor's asset because there is no contractual requirement for the insurance proceeds to be used for that purpose. Consequently, we believe it is reasonable to conclude that the insurance primarily benefits the lessee; providing assurance to the lessee that it will be able to fulfill its obligation to return the underlying asset to the lessor without having to pay for replacement of, or significant repairs to, the underlying asset out of its own funds.

#### **Approach 2: Insurance required by lease contract**

The lessor is the primary beneficiary whenever the insurance policy is on the underlying asset and obtaining the insurance is a requirement of the lease contract.

This approach to determining the primary beneficiary is based on the notion that if the lessor did not believe that the insurance principally protects its investment in the underlying asset it would not have required that the lessee obtain insurance as a condition of granting the lease.



**Question 4.2.45**

**Effect of lease classification on identifying lessor costs**

#### **Is the determination of whether property tax or insurance payments are lessor or lessee costs affected by lease classification?**

**Interpretive response:** No. We do not believe the framework for identifying when property taxes and insurance are lessor costs outlined in Question 4.2.40 differs based on classification of the lease. Based on discussions with the FASB staff, we understand that they share this view.

This conclusion is based on the fact that lease classification will frequently only be incidental to whether property taxes or insurance on the underlying asset represents a lessor cost under the Question 4.2.40 framework.

From the lessee perspective, even if a lessor concludes that the classification of the lease is sales-type or direct financing (and therefore derecognizes the underlying asset), the lessor still legally owns the asset and therefore will frequently still be the primary obligor for any property (or similar) taxes related to the underlying asset, and/or the primary beneficiary of any insurance on the asset (see Question 4.2.42).

From the lessor perspective, classification of the lease will not affect whether the lessee or the lessor remits the property tax or pays the insurance premium to the relevant third party.



### Example 4.2.10

#### Differentiating lessor insurance costs from lessee insurance costs

##### **Scenario 1: Lessee is primary beneficiary**

Lessee LE and Lessor LR enter into a two-year residential apartment lease that requires LE to maintain renter's insurance coverage with LR listed as an additional insured on the policy (LE is the named insured). LE obtains this coverage through a third-party insurance company concurrently with obtaining the lease. The insurance premium will vary and will be billed to LE each year.

Even though obtaining the renter's insurance is a requirement of the lease contract, the premiums associated with the renter's insurance policy represent an executory cost of LE and not a cost of LR that LE is paying as a condition of the lease. This is because, whether applying Approach 1 or Approach 2 to Question 4.2.42, the insurance policy is not on the underlying asset; rather, it serves to protect LE's property from certain loss events (e.g. fire or theft) and to cover LE's liability for any visitor injuries in the apartment.

##### **Scenario 2: Lessor is primary beneficiary**

Lessee LE and Lessor LR enter into a standard three-year car lease that requires LE to maintain collision insurance coverage on the car throughout the lease term. LR is entitled to any proceeds if the car is a writeoff and has the right to ensure that proceeds paid to LE are used to repair the vehicle if it is not a writeoff – LR must sign the insurance reimbursement check for LE to collect on a claim.

LE contracts with a third-party insurance company to obtain the required coverage. The insurance premium will vary and will be billed to LE each year.

The insurance coverage in this example primarily benefits LR (regardless of the approach taken in Question 4.2.42); it protects LR's investment in the car.

Therefore, the insurance is not a component (lease or non-lease) of the contract and LE's payments for the insurance premiums represent variable payments of LR's cost.



### Question 4.2.50

#### Accounting for gross and net leases

##### How does the accounting differ for gross vs. net leases?

**Interpretive response:** Examples 4.2.20 – 4.2.50 illustrate differences in the accounting for gross leases (i.e. those for which payments of lessor costs are fixed as part of the rental payments) versus net leases – i.e. those for which lessees make variable payments to the lessor or a third party. Lessees will generally recognize smaller ROU assets and lease liabilities for a net lease than for a gross lease because lessees will not include estimates of variable payments in those amounts. [842-10-55-141 – 55-143]

Variable payments for lessor costs of property taxes and insurance (see Questions 4.2.40 and 4.2.45), while not part of the ‘consideration in the contract’, are not excluded from lease accounting in a net lease scenario. Depending on whether the contract also includes non-lease components, either all or a portion of the variable payments for the property taxes or insurance will be accounted for as variable lease payments (see sections 5.4, 6.3 and 7.3 – 7.4). Lessees and lessors will need to track such variable lease payments for disclosure purposes – i.e. disclosures of variable lease cost/income (see sections 12.2 – 12.3). [842-10-15-40 – 15-40A, 842-20-50-4(d), 842-30-50-5(c)]

We believe the Board recognized that economically similar contracts will be accounted for differently on the balance sheet as a result of its decision on variable payments. However, that different accounting result will not be unique to gross versus net lease scenarios. Similarly, a retail lessee required to make fixed payments of \$10,000 per month will recognize an ROU asset and lease liability significantly different from a retail lessee that is required to make payments expected to approximate \$10,000 per month comprising a fixed payment of \$5,000 per month plus a variable payment of 2% of store sales for the previous month.



### Example 4.2.20

#### Identifying components in gross and net leases

Two companies enter into similar leases of a building, but with the underlying contracts structured differently.

##### Scenario 1: Gross lease

Lessee LE1 leases a building from Lessor LR1 for 24 months.

LE1 pays LR1 \$20,000 per month with no separate obligation with respect to LR1’s property taxes or building insurance (i.e. the lease is a gross lease).

The contract has a single component, which is the lease of the building. The consideration in the contract (see section 4.3) is \$480,000 (\$20,000 × 24). As outlined in Step 4 (see section 4.4), that amount is allocated entirely to the single component of the contract (the building lease component).

### Scenario 2: Net lease

Lessee LE2 leases a similar building from Lessor LR2.

LE2 pays LR2 \$18,000 per month and must reimburse LR2 for LR2's actual property tax assessments and building insurance costs during the lease term (i.e. the lease is a net lease). Costs of the property taxes and insurance are expected to approximate \$2,000 per month but will vary based on actual tax assessments and insurance premiums.

- LE2 concludes that the property taxes and insurance are lessor costs because LR2 is primarily obligated to the taxing authority for the property taxes and primarily benefits from the building insurance (LR2 is the owner and named beneficiary of the insurance policy) – see Questions 4.2.40 and 4.2.42.
- LR2 concludes that the property taxes and insurance are lessor costs because it pays the property taxes and insurance premiums and LE2's payments reimburse LR2 – see Question 4.2.40.

Although the contract includes the explicit requirement for LE2 to reimburse LR2's property tax and insurance costs, these are not components of the contract. Therefore, as in Scenario 1, the contract has only a single component (i.e. the lease of the building).

There are two types of payments in the contract:

- The fixed payments of \$18,000 per month are included in the consideration in the contract.
- The variable payments (approximately \$2,000 per month) are not included in the consideration in the contract. Because there are no non-lease components of the contract, the additional considerations applicable to lessors for variable payments (see section 4.3.2) are not applicable and the variable reimbursement payments are entirely variable *lease* payments. Such amounts are recognized as incurred (lessee) or earned (lessor).

Like Scenario 1, the contract has a single component, which is the lease of the building. The consideration in the contract (see section 4.3) is \$432,000 (\$18,000 × 24). As outlined in Step 4 (see section 4.4), that amount is allocated entirely to the single component of the contract.

### Comparing Scenarios 1 and 2

This example illustrates the following key points.

- Property taxes and insurance obligations of the lessor are not lease or non-lease components of a contract.
- Variable payments not dependent on an index or rate are excluded from the consideration in the contract.
- The consideration in the contract is allocated only to the separate lease and non-lease components of the contract.
- When there are no non-lease components of the contract, variable payments of lessor costs (which include reimbursements of the lessor property tax and insurance costs) are accounted for as variable lease payments.



### Example 4.2.30

#### Property taxes and insurance in a gross lease

Lessee LE and Lessor LR enter into a five-year lease of retail space that includes CAM throughout the lease term. LE will pay LR a fixed payment of \$106,000 per year (in arrears) for Year 1, increasing by \$5,000 each year thereafter.

LE has no separate obligation to pay LR for its property taxes, insurance or CAM. Of the annual fixed payment, approximately \$15,000 is expected to cover LR's property tax assessments and building insurance costs, and approximately \$5,200 is expected to cover LR's actual CAM costs.

Initial direct costs are \$5,000 (broker commissions) for both LE and LR.

LR provides a moving allowance (i.e. a lease incentive) to LE of \$7,500, which it pays at lease commencement.

#### Consideration in the contract

##### *Lessee LE*

The consideration in the contract is \$572,500, equal to:

- the sum of the payments of \$106,000 for Year 1 increasing \$5,000 each year thereafter (\$580,000 in total); less
- the lease incentive received of \$7,500.

##### *Lessor LR*

The consideration in the contract for LR is the same as it is for LE (\$572,500).

#### Allocation to components

If LR and LE separate the lease and CAM components (see separation and non-separation scenarios presented below), they will allocate the consideration in the contract in proportion to the stand-alone (selling) prices of the components.

The stand-alone (selling) prices are assumed to be \$570,000 (lease) and \$30,000 (CAM).

- The estimated stand-alone (selling) price of CAM equals the estimated actual CAM cost reimbursements plus an assumed market-based profit margin for those CAM services.
- The estimated stand-alone (selling) price of the lease is an estimate of what a lessor would charge for the lease without providing CAM (while still recovering its property tax and insurance costs through the fixed lease payments).

Component	Stand-alone price	Allocation	Calculation
Lease	\$570,000	\$543,875	(570,000 / 600,000) × 572,500
CAM	30,000	28,625	(30,000 / 600,000) × 572,500
	<b>\$600,000</b>	<b>\$572,500</b>	

The allocation results in 95% of the consideration in the contract being allocated to the lease component and 5% being allocated to the CAM non-lease component.

Assuming the lease is an *operating lease*, the initial and day 2 accounting for that lease is as follows.

#### **Lessee LE elects to separate lease and non-lease components**

The rate implicit in the lease is not readily determinable and therefore LE uses its incremental borrowing rate of 5%. LE determines its lease liability by calculating the present value of the allocated unpaid lease payments of \$551,000 (equal to \$543,875 of allocated lease payments + an allocation of the lease incentive of \$7,125, which is \$7,500 received up-front × 95%), discounted at 5%, to arrive at the lease liability initial measurement of \$475,104.

- LE's initial measurement of its ROU asset is \$472,979, calculated as follows:

$$\text{Lease liability } (\$475,104) + \text{Initial direct costs } (\$5,000) + \text{Prepaid lease payments (none)} - \text{Lease incentives received } (\$7,125, \text{ which is } \$7,500 \times 95\%)$$

- LE's total lease cost is \$548,875 (allocated lease payments of \$543,875, which is net of allocated lease incentives of \$7,125, + initial direct costs of \$5,000), which is recognized straight-line over the lease term – i.e. \$109,775 each year.

#### **Lessee LE elects not to separate lease and non-lease components**

Assume the rate implicit in the lease is not readily determinable and therefore LE uses its incremental borrowing rate of 5%. LE determines its lease liability by calculating the present value of the unpaid payments of \$580,000, discounted at 5% to arrive at the lease liability initial measurement of \$500,109.

- LE's initial measurement of its ROU asset is \$497,609, calculated as follows:

$$\text{Lease liability } (\$500,109) + \text{Initial direct costs } (\$5,000) + \text{Prepaid lease payments (none)} - \text{Lease incentives received } (\$7,500)$$

- LE's total lease cost is \$577,500 (payments of \$580,000 + initial direct costs of \$5,000 – lease incentives received of \$7,500), which is recognized straight-line over the lease term – i.e. \$115,500 each year.

#### **Lessor LR elects to separate lease and non-lease components**

Because the lease is an operating lease, LR continues to recognize and depreciate the asset. At lease commencement, LR defers the \$5,000 of initial direct costs and amortizes them as an expense over the lease term on the same basis as the lease income (i.e. \$1,000 of amortization each year) – in this case, the initial direct costs were allocated entirely to the lease component. Judgment will be involved in determining whether initial direct costs, such as a broker's commission, relate to a lease component, a non-lease component, or both (see section 5.5). If, instead, a portion of the broker's commission was allocated to the CAM non-lease component, those costs would not be *initial direct costs* but rather would be accounted for under Subtopic 340-40 (other assets and deferred costs related to contracts with customers).

LR recognizes lease income of \$543,875 (which is net of an allocated amount of the lease incentive paid) on a straight-line basis over the lease term (i.e. \$108,775 of lease income each year).

LR recognizes CAM revenue of \$28,625 (which is net of an allocated amount of the lease incentive paid) over the lease term based on an appropriate measure of progress determined in accordance with paragraphs 606-10-25-31 – 25-37.

**Lessor LR elects not to separate lease and non-lease components**

LR has elected the practical expedient not to separate the lease and non-lease components for its retail space leases (see paragraphs 4.4.51 – 4.4.56), and has determined that the CAM non-lease component qualifies for non-separation in this lease because:

- the retail space lease would be classified as an operating lease if accounted for separately (see Question 4.4.12); and
- the CAM, like the operating retail space lease, is satisfied over time (i.e. LE simultaneously receives and consumes benefit from the CAM) and it has a time-elapsed (i.e. straight-line) pattern of transfer to LE (see Question 4.4.13).

Further, LR determines that the CAM element is not the predominant element of the combined component – i.e. the retail space is the predominant element. Therefore, the combined component is accounted for as a single *lease* component classified as an operating lease (see paragraphs 4.4.53 – 4.4.55).

Consistent with the LR separation scenario, LR continues to recognize and depreciate the underlying asset. At lease commencement, LR defers the \$5,000 of initial direct costs and amortizes them as an expense over the lease term on the same basis as the lease income.

LR recognizes lease income of \$572,500 (\$580,000 net of the \$7,500 lease incentive paid) on a straight-line basis over the lease term – i.e. \$114,500 of lease income each year.



#### Example 4.2.40

#### Property taxes and insurance in a net lease – lessee reimburses lessor

Lessee LE and Lessor LR enter into a five-year lease of retail space that includes CAM services throughout the lease term. LE will pay LR a fixed payment of \$90,200 per year (in arrears) for Year 1, increasing by \$5,000 per year thereafter. The lease is (or would be, if accounted for separately by LR) classified as an operating lease because:

- there are no title transfer provisions or lessee purchase options;
- the remaining economic life of the building in which the retail space is located is 30 years;
- the fair value of the retail space significantly exceeds even the undiscounted lease and non-lease payments due under the contract; and
- the retail space is not specialized.

LE reimburses LR for its pro rata portion of LR's actual property taxes, insurance costs and CAM costs during the lease term. LR estimates its property tax assessments and building insurance costs will be approximately \$15,000 per year and its CAM costs will be approximately \$5,200 per year.

Consistent with Question 4.2.40:

- LE concludes that the property taxes and insurance are lessor costs because LR is primarily obligated to the taxing authority for the property taxes and primarily benefits from the building insurance (LR is the owner and named beneficiary of the insurance policy).
- LR concludes that the property taxes and insurance are lessor costs because it pays the property taxes and insurance premiums and LE's payments reimburse LR.

Initial direct costs are \$5,000 (broker commissions) for both LE and LR.

LR provides a moving allowance (i.e. a lease incentive) to LE of \$7,500, which it pays at lease commencement.

### **Consideration in the contract**

#### ***Lessee LE***

The consideration in the contract is \$493,500, equal to the sum of the payments of \$90,200 for Year 1 and increasing \$5,000 each year thereafter (\$501,000 in total), less the lease incentive received of \$7,500. The amounts LE expects to pay to LR for property taxes, insurance and CAM are variable payments that are excluded from LE's measurement of the consideration in the contract because they do not depend on an index or rate (and are not in-substance fixed).

#### ***Lessor LR elects to separate lease and non-lease components***

The consideration in the contract is \$519,500, equal to the sum of the payments of \$90,200 for Year 1 and increasing \$5,000 each year thereafter (\$501,000 in total), less the lease incentive received of \$7,500 plus \$26,000 of expected payments for CAM. LR concludes it is appropriate to include the \$26,000 in expected CAM payments because those variable payments to which it expects to be entitled specifically relate to its effort to provide CAM (a non-lease component).

LR arrives at \$26,000 using the variable consideration requirements in Topic 606:<sup>1</sup>

- LR estimates it will be entitled to \$26,000 in variable payments for CAM; and
- LR concludes it is probable that including that amount in the consideration in the contract will not result in a significant revenue reversal of cumulative revenue recognized for the lease and the CAM when the variability around those payments is resolved.

Note:

1. Paragraphs 606-10-32-5 – 32-13 govern this initial estimate of \$26,000. Estimates of variable consideration for CAM need to be updated each reporting period under paragraph 606-10-32-14. If the entity allocates the estimated CAM variable payments entirely to the CAM non-lease component initially, subsequent changes to that estimate will also generally be allocated entirely to the CAM non-lease component.

The amounts LR expects LE to reimburse LR for property taxes and insurance are variable payments that are excluded from LR's measurement of the consideration in the contract because they:

- do not depend on an index or rate;
- are not in-substance fixed; and
- do not relate solely to LR's efforts to provide a non-lease good or service to LE.

However, because the property taxes and insurance are LR costs (rather than LE costs), LE's variable payments are recognized separately (i.e. on a gross basis) from LR's associated property tax and insurance costs (see Gross vs. net considerations in section 7.3.2) and allocated to the lease and non-lease components.

#### **Lessor LR elects not to separate lease and non-lease components**

LR elects the lessor practical expedient discussed in section 4.4.1 for its retail space leases. The retail space lease and the CAM in this example qualify for combination as described in paragraph 4.4.51.

LR determines that the CAM is *not* the predominant element of the combined component. Therefore, the combined component is accounted for as a single, operating lease component (see paragraphs 4.4.53 – 4.4.55).

Because there is only a single lease component in the contract, the variable payments LE will make to LR under the contract for property taxes, insurance and CAM are all considered to relate to that lease component (see paragraph 4.3.75). Therefore:

- none of those expected variable payments are included in the consideration in the contract (see Question 4.3.10); and
- all of them will be accounted for as variable *lease* payments (that do not depend on an index or rate and are not in-substance fixed).

Consequently, the consideration in the contract is \$493,500: \$501,000 of fixed lease payments, less the lease incentive received of \$7,500.

#### **Allocation of the consideration in the contract to components**

If LR and LE separate the lease and the CAM components of this contract, they allocate the consideration in the contract in proportion to the stand-alone (selling) prices of the two components as follows. The stand-alone (selling) prices are determined to be \$570,000 (lease) and \$30,000 (CAM), consistent with Example 4.2.30. The estimated stand-alone selling price of CAM includes the estimated cost reimbursements, plus an assumed market-based profit margin for providing those services.

In contrast, if LR and LE elect not to separate the lease and the CAM components of this contract (and the two components qualify for combination in the case of LR), there is no allocation of the consideration in the contract or the variable payments between the lease and the CAM.

#### **Lessee LE elects to separate lease and non-lease components**

LE allocates the consideration in the contract of \$493,500 in proportion to stand-alone prices.

Component	Stand-alone price	Allocation	Calculation
Lease	\$570,000	\$468,825	$(570,000 / 600,000) \times 493,500$
CAM	30,000	24,675	$(30,000 / 600,000) \times 493,500$
	<b>\$600,000</b>	<b>\$493,500</b>	

The allocation results in 95% of the consideration in the contract being allocated to the lease component and 5% being allocated to the CAM non-lease component.

#### **Lessee LE elects not to separate lease and non-lease components**

Because LE elects not to separate the lease and the CAM components, the entire consideration in the contract of \$493,500 is allocated to the single lease component.

#### **Lessor LR separates lease and non-lease components**

*The following is an example of how the allocation requirements may be applied; other methods may be appropriate based on the facts and circumstances.*

The consideration in the contract for LR is measured at \$519,500.

LR begins by allocating to the CAM the variable payments specifically related to its efforts to satisfy that non-lease component. Allocation of *only* the CAM variable payments to the CAM component would be inconsistent with the allocation objective in paragraph 606-10-32-28. This is because LR is billing only its costs with no assumption of profit, and therefore, the variable payments alone do not reflect the price at which LR would sell CAM separately to a customer. Therefore, the remaining consideration in the contract (\$493,500, which does not include variable payments for taxes and insurance) is allocated on a relative stand-alone selling price basis, after adjusting for the variable payments that have been specifically allocated to the non-lease component.

LR allocates the consideration in the contract to the lease and the CAM component as follows.

Component	Stand-alone price	Allocation	Calculation
Lease	\$570,000	\$490,061	$(570,000 / 574,000^1) \times 493,500$
CAM	30,000	29,439	$(4,000 / 574,000^1) \times 493,500 + 26,000$
	<b>\$600,000</b>	<b>\$519,500</b>	

The allocation results in 94% of the consideration in the contract being allocated to the lease component and 6% being allocated to the maintenance non-lease component.

Note:

1. The total of the stand-alone selling prices used in the calculations (\$574,000) has been adjusted to remove the \$26,000 that has already been specifically allocated to the non-lease maintenance component (\$600,000 total stand-alone selling price less the amount of variable consideration attributed to the non-lease component of \$26,000).

### **Lessor LR elects not to separate lease and non-lease components**

The consideration in the contract for LR is measured at \$493,500.

Because (1) LR elects not to separate the lease component and the CAM non-lease component, and (2) the CAM is not the predominant element of the combined lease/CAM component, the entire consideration in the contract of \$493,500 is allocated to the single lease component.

### **Accounting for lease and non-lease components**

#### **Lessee LE elects to separate lease and non-lease components**

Assume the rate implicit in the lease is not readily determinable and therefore LE uses its incremental borrowing rate of 5%. LE determines its lease liability by calculating the present value of the allocated unpaid lease payments of \$475,950 (equal to \$468,825 of allocated unpaid lease payments + an allocation of the lease incentive of \$7,125, which is \$7,500 received  $\times$  95%), discounted at 5%, to arrive at the lease liability initial measurement of \$410,118.

- LE's initial measurement of its ROU asset is \$407,993, calculated as follows:

$$\text{Lease liability } (\$410,118) + \text{Initial direct costs } (\$5,000) + \text{Prepaid lease payments (none)} - \text{Lease incentives received } (\$7,125 [\$7,500 \times 95\%])$$

- LE's total lease cost is \$473,825 (allocated lease payments, net of allocated lease incentives, of \$468,825 + initial direct costs of \$5,000) and is recognized straight-line over the lease term – i.e. \$94,765 each year.
- Amounts allocated to CAM of \$24,675 (which is net of allocated lease incentives of \$375) are recognized over the service period.
- Payments for property taxes, building insurance and CAM are variable payments. These variable payments would be allocated in the same manner as fixed payments (i.e. 95% to the lease component and 5% to CAM) and recognized as incurred.

#### **Lessee LE elects not to separate lease and non-lease components**

The rate implicit in the lease is not readily determinable and therefore LE uses its incremental borrowing rate of 5%. LE determines its lease liability by calculating the present value of the unpaid lease payments of \$501,000 (\$493,500 of unpaid lease payments + lease incentive of \$7,500), discounted at 5%, to arrive at the lease liability initial measurement of \$431,703.

- LE's initial measurement of its ROU asset is \$429,203:

$$\text{Lease liability } (\$431,703) + \text{Initial direct costs } (\$5,000) + \text{Prepaid lease payments (none)} - \text{Lease incentives received } (\$7,500)$$

- LE's total lease cost is \$498,500 (lease payments, net of lease incentives, of \$493,500 + initial direct costs of \$5,000) and is recognized on a straight-line basis over the lease term – i.e. \$99,700 each year.
- Payments LE makes for property taxes, building insurance and CAM throughout the lease term are accounted for as variable lease payments because there is only a single lease component of the contract.

### **Lessor LR separates lease and non-lease components**

Because the lease is an operating lease, LR continues to recognize and depreciate the underlying asset. At lease commencement, consistent with Example 4.2.30, LR defers the \$5,000 of initial direct costs and amortizes them as an expense over the lease term on the same basis as the lease income (i.e. \$1,000 of amortization each year). If a portion of the broker's commission had been allocated to the CAM (non-lease component), those costs would not be initial direct costs but rather would be accounted for under Subtopic 340-40.

LR recognizes lease income of \$490,061 (which is net of an allocated amount of the \$7,500 lease incentive paid) on a straight-line basis over the lease term – i.e. \$98,012 of lease income per year.

LR recognizes the consideration in the contract allocated to the CAM (non-lease component) of \$29,439 (i.e. CAM revenue) on a straight-line basis (i.e. using a time-elapsed measure of progress, determined to be appropriate under paragraphs 606-10-25-31 – 25-37). Estimates of the variable consideration that will be earned for CAM will need to be updated each reporting period in accordance with paragraph 606-10-32-14. Changes in the consideration in the contract are allocated to the lease and/or non-lease components based on the guidance for changes in the transaction price in Topic 606. Consequently, changes in the consideration in the contract as a result of changes to the estimate of CAM reimbursements will be allocated entirely to the CAM non-lease component, consistent with how the consideration in the contract was originally allocated.

Reimbursements of LR property tax and insurance costs are variable payments that are not part of the consideration in the contract either at contract inception or subsequently. In this example, LR allocates the variable payments it receives for property taxes and insurance entirely to the lease component – i.e. accounting for those payments entirely as variable lease payments – because:

- charges for property taxes and insurance relate specifically to LR's ownership of the property, which permits LR to provide the right to use the retail space; and
- allocating the property taxes and insurance payments entirely to the lease component is consistent with the allocation objective in Topic 606 because it would result, given the amounts LR expects LE to pay, in total income recognition for the lease (\$565,061) and non-lease (\$29,439) components that approximates each component's stand-alone selling price.

All facts and circumstances must be considered; lessors should carefully consider whether their overall allocation methodology yields reported results for the lease and non-lease components that are consistent with the allocation objective in paragraph 606-10-32-28.

LR recognizes the variable property tax and insurance payments as variable lease income when the changes in facts and circumstances on which the payments are based occur.

### **Lessor LR elects not to separate lease and non-lease components**

Consistent with the accounting by LR when it elects to separate the lease and the CAM, because the lease is an operating lease, LR continues to recognize

and depreciate the underlying asset, and defer and amortize the initial direct costs over the lease term.

LR recognizes lease income of \$493,500 on a straight-line basis over the lease term – i.e. \$98,700 of lease income per year. Because LR accounts for the lease and the CAM as a single, combined lease component, the variable payments LE will make to LR for property taxes, insurance and CAM are accounted for entirely as variable lease payments, which means they:

- do not change the consideration in the contract when they become owed to LR; and
- are recognized as variable lease income when the changes in facts and circumstances on which the payments are based occur.



### Example 4.2.50

#### **Property taxes and insurance in a net lease – lessee pays third party directly (lessor accounting)**

*Only Lessor LR's accounting is illustrated in this example. Because the numbers used in this example are the same as those used in Example 4.2.40, Lessee LE's accounting is the same in both examples.*

Lessee LE and Lessor LR enter into a five-year lease of a building that includes maintenance of the building by LR throughout the lease term. LE will pay LR a fixed payment of \$90,200 per year (in arrears) for Year 1, increasing by \$5,000 per year thereafter. The lease is (or would be, if accounted for separately by LR) classified as an operating lease because:

- there are no title transfer provisions or lessee purchase options;
- the remaining economic life of the building is 30 years;
- the fair value of the building significantly exceeds the undiscounted lease and non-lease payments due under the contract; and
- the building is not specialized.

Under the contract, LE is required to pay the building's property taxes directly to the local taxing authority and obtain hazard insurance on the building for which LR is to be the named insured. LE will reimburse LR for its actual building maintenance costs during the lease term. LR estimates the property tax assessments and building insurance costs will be approximately \$15,000 per year and its maintenance costs will be approximately \$5,200 per year. LR concludes the property taxes and insurance are lessee costs because LE will pay those costs to the taxing authority and insurer directly (see Question 4.2.40).

Initial direct costs are \$5,000 (broker commissions) for both LE and LR.

LR provides a moving allowance (i.e. a lease incentive) to LE of \$7,500, which LR pays at lease commencement.

## Consideration in the contract

### **Lessor LR elects to separate lease and non-lease components**

The consideration in the contract is \$519,500, equal to the sum of the payments of \$90,200 for Year 1 increasing by \$5,000 each year thereafter (\$501,000 in total), less the lease incentive received of \$7,500, plus \$26,000 of expected payments for maintenance.

LR concludes that it is appropriate to include the \$26,000 in expected maintenance payments in the consideration in the contract because the variable payments to which it expects to be entitled specifically relate to its effort to provide maintenance (a non-lease component).

LR arrives at \$26,000 using the variable consideration requirements in Topic 606:<sup>1</sup>

- LR estimates that it will be entitled to \$26,000 in variable payments for maintenance; and
- LR concludes that it is probable that including that amount in the consideration in the contract will not result in a significant revenue reversal of cumulative revenue recognized for the lease and the maintenance when the variability around those payments is resolved.

Note:

1. Paragraphs 606-10-32-5 – 32-13 govern this initial estimate of \$26,000. Estimates of variable consideration for maintenance will need to be updated each reporting period in accordance with paragraph 606-10-32-14. If the entity allocates the estimated maintenance variable payments entirely to the maintenance non-lease component initially, subsequent changes to that estimate will also generally be allocated entirely to the maintenance non-lease component.

Because the property tax and insurance costs are LE costs (rather than LR costs), neither the costs, nor LE's payments thereof, are reflected in LR's accounting for the lease (see paragraph 4.2.150).

### **Lessor LR elects not to separate lease and non-lease components**

LR elects the lessor practical expedient discussed in section 4.4.1 for its building leases. The building lease and the maintenance in this example qualify for combination as described in paragraph 4.4.51.

LR determines that the maintenance is *not* the predominant element of the combined component. Therefore, the combined component is accounted for as a single, operating lease component (see paragraphs 4.4.53 – 4.4.55).

Because there is only a single lease component in the contract, the variable payments LE will make to LR under the contract for maintenance are considered to relate to that lease component (see paragraph 4.3.75). Therefore:

- none of the expected variable payments are included in the consideration in the contract (see Question 4.3.10); and
- they will be accounted for as variable *lease* payments (that do not depend on an index or rate and are not in-substance fixed).

Consequently, the consideration in the contract is \$493,500: \$501,000 of fixed lease payments less the lease incentive received of \$7,500.

Because the property tax and insurance costs are LE costs (rather than LR costs), neither the costs, nor LE's payments thereof, are reflected in LR's accounting for the lease.

### **Allocation of the consideration in the contract to components**

If LR separates the lease and the maintenance components of this contract, it allocates the consideration in the contract in proportion to the stand-alone selling prices of the two components.

The stand-alone selling prices are determined to be \$495,000 (lease) and \$30,000 (maintenance).

- The estimated stand-alone selling price of maintenance equals the estimated actual maintenance cost reimbursements plus an assumed market-based profit margin for the maintenance.
- The estimated stand-alone selling price of the lease is an estimate of what a lessor would charge for the lease without providing maintenance. Unlike Examples 4.2.30 and 4.2.40, LR's estimated stand-alone selling price does *not* include recovery of property tax and insurance costs; this is because they are LE costs in this example.

In contrast, if LR elects not to separate the lease and the maintenance components of this contract, and the two components qualify for combination, there is no allocation of the consideration in the contract or the variable payments between the lease and the maintenance.

### **Lessor LR separates lease and non-lease components**

*The following is an example of how the allocation requirements may be applied; other methods may be appropriate based on the facts and circumstances.*

The consideration in the contract for LR is measured at \$519,500.

LR begins by allocating to the maintenance the variable payments specifically related to its efforts to satisfy that non-lease component. Allocation of *only* the variable maintenance payments to the maintenance component would be inconsistent with the allocation objective in paragraph 606-10-32-28. This is because LR is billing only its costs with no assumption of profit, and therefore the variable payments alone do not reflect the price at which LR would sell maintenance separately to a customer. Therefore, the remaining consideration in the contract (\$493,500, which does not include variable payments for taxes and insurance) is allocated on a relative stand-alone selling price basis, after adjusting for the variable payments that have been specifically allocated to the non-lease component.

LR allocates the consideration in the contract to the lease and the maintenance component as follows.

Component	Stand-alone price	Allocation	Calculation
Lease	\$495,000	\$489,544	$(495,000 / 499,000^1) \times 493,500$
Maintenance	30,000	29,956	$(4,000 / 499,000^1) \times 493,500 + 26,000$
	<b>\$525,000</b>	<b>\$519,500</b>	

The allocation results in approximately 94% and 6% of the consideration in the contract being allocated to the lease component and the maintenance, respectively.

Note:

1. The total of the stand-alone selling prices used in the calculations (\$499,000) has been adjusted to remove the \$26,000 that has already been specifically allocated to the non-lease maintenance component (\$525,000 total stand-alone selling price less the amount of variable consideration attributed to the non-lease component of \$26,000).

#### **Lessor LR elects not to separate lease and non-lease components**

The consideration in the contract for LR is measured at \$493,500.

Because (1) LR elects not to separate the lease component and the maintenance non-lease component, and (2) the maintenance is not the predominant element of the combined lease/maintenance component, the entire consideration in the contract of \$493,500 is allocated to the single lease component.

#### **Accounting for lease and non-lease components**

##### **Lessor LR separates lease and non-lease components**

Because the lease is an operating lease, LR continues to recognize and depreciate the underlying asset. At lease commencement, consistent with Example 4.2.40, LR defers the \$5,000 of initial direct costs and amortizes them to expense over the lease term on the same basis as the lease income (i.e. \$1,000 of amortization each year). If a portion of the broker's commission had been allocated to the maintenance (non-lease component), those costs would not be initial direct costs but rather would be accounted for under Subtopic 340-40.

LR recognizes lease income of \$489,544 (which is net of an allocated amount of the \$7,500 lease incentive paid) on a straight-line basis over the lease term – i.e. \$97,909 of lease income per year.

LR recognizes the consideration in the contract allocated to the maintenance (non-lease component) of \$29,956 (i.e. maintenance revenue) on a straight-line basis (i.e. using a time-elapsed measure of progress, determined to be appropriate under paragraphs 606-10-25-31 – 25-37). Estimates of the variable consideration that will be earned for maintenance will need to be updated each reporting period under paragraph 606-10-32-14. Changes in the consideration in the contract are allocated to the lease and/or non-lease components based on the guidance for changes in the transaction price in Topic 606. Consequently, changes in the consideration in the contract as a result of changes to the estimate of maintenance reimbursements will be allocated entirely to the maintenance non-lease component, consistent with how the consideration in the contract was originally allocated.

As explained earlier in this example, because the property tax and insurance costs are LE costs (rather than LR costs), neither the costs, nor LE's payments thereof, are reflected in LR's accounting for the lease.

### **Lessor LR elects not to separate lease and non-lease components**

Because the lease is an operating lease, LR continues to recognize and depreciate the underlying asset, and defer and amortize the initial direct costs over the lease term.

LR recognizes lease income of \$493,500 on a straight-line basis over the lease term – i.e. \$98,700 of lease income per year. Because LR accounts for the lease and the maintenance as a single, combined lease component, the variable payments LE will make to LR for maintenance are accounted for entirely as variable lease payments, which means they:

- do not change the consideration in the contract when they become owed to LR; and
- are recognized as variable lease income when the changes in facts and circumstances on which the payments are based occur.

Neither the property tax and insurance costs, nor LE's payments thereof, are reflected in LR's accounting for the lease.

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### **Sales and other similar taxes**

4.2.170 'Sales and other similar taxes' refers to taxes assessed by a governmental authority that are both imposed on and concurrent with a specific lease revenue-producing transaction. Other similar taxes include use, value added taxes (VAT) and some excise taxes. Such taxes exclude (1) gross receipts taxes and (2) taxes assessed on the lessor as owner of the underlying asset. Question 5.2.05 and Example 5.2.05 in KPMG Handbook, [Revenue Recognition](#), provide additional guidance on identifying 'sales and other similar taxes'. [842-10-15-39A]

4.2.180 Taxes assessed on the lessor as owner of the underlying asset include (not exhaustive):

- most property taxes; and
- sales taxes assessed on the owner's purchase of the underlying asset.

4.2.190 Sales and other similar taxes are incurred differently in different jurisdictions. In some jurisdictions, the prevailing tax rate is applied to each lease payment throughout the lease term – e.g. X% of each lease payment. In other jurisdictions, tax is incurred before lease commencement and is based on, for example, the purchase price of the underlying asset or the total gross lease payments that will be made over the lease term.

4.2.200 Lessors only, as an accounting policy election applied to all leases, may choose to present all funds collected from lessees for sales and other similar taxes net of the related sales tax expense. A lessor electing this practical expedient must disclose its election and comply with the disclosure requirements in Topic 235. See Question 4.4.17 for changes to the election of a practical expedient, including the sales and other similar taxes practical expedient. [842-10-15-39A, 842-30-50-14]

4.2.210 A lessor that does not elect the practical expedient assesses whether all sales and other similar taxes are lessee or lessor costs in the same way as it does for property taxes (see Question 4.2.40), and then accounts for those

taxes and the lessee's payment thereof as prescribed in paragraph 4.2.150 (if the tax is a lessee cost) or paragraph 4.2.160 (if the tax is a lessor cost).

4.2.220 Sections 13A.4.3 (effective date transition method) and 13B.4.3 (comparative transition method) discuss the effective date and transition provisions applicable to ASU 2018-20.

## Question 4.2.60 Sales and other similar taxes

### Are sales and other similar taxes paid by the lessee part of the consideration in the contract?

**Interpretive response:** The accounting for sales and other similar taxes is different for the lessee versus the lessor.

#### Lessee accounting

We believe the appropriate accounting by a lessee for its tax payments depends on whether:

- the lessee or the lessor is the primary obligor for the tax; and
- the tax is incurred at or before lease commencement or over the lease term.

#### Lessee is the primary obligor

The tax amount paid is not part of the 'consideration in the contract', whether fixed or variable. The lessor, when it collects and remits the sales tax to the taxing authority, is merely a collection agent for the taxing authority. As summarized in the following table, the appropriate lessee accounting is based on when the tax liability is incurred by the lessee.

Tax is incurred:	
Over the lease term	At or before lease commencement
The tax is a variable, executory (non-lease) cost of the lessee that should be accounted for in the same manner as any other period cost. It should not be capitalized as part of the cost of the ROU asset.	<p>Consistent with the lessee's accounting policy elected in accordance with Question 5.1.10, the tax should be either:</p> <ul style="list-style-type: none"> <li>— capitalized as part of the cost of the ROU asset by analogy to the guidance in Topic 360 (property, plant and equipment); or</li> <li>— expensed as incurred.</li> </ul> <p>Even if the tax will be paid over time, the obligation to make the fixed tax payments over time should be recognized at lease commencement. However, the corresponding liability is not a part of the lease liability because the tax payments are not 'lease payments' (because the tax is a lessee cost). Instead, the obligation to make the fixed tax payments over time</p>

<b>Tax is incurred:</b>	
<b>Over the lease term</b>	<b>At or before lease commencement</b>
	should be recognized as a separate financial liability.

### **Lessor is the primary obligor**

If the lessee pays the lessor's tax obligation (i.e. the tax is a lessor cost – see Question 4.2.40) on a nonrefundable basis, the following table summarizes the lessee's accounting. This accounting applies regardless of whether payment is made to the lessor or directly to a taxing authority (or other third party).

<b>Tax is incurred:</b>	
<b>Over the lease term</b>	<b>At or before lease commencement</b>
The lessee's tax payments are variable payments not part of the consideration in the contract that should be accounted for as outlined in section 4.4.3.	It is part of the consideration in the contract and accounted for in the same manner as any other amount that is part of the consideration in the contract.

### **Lessor accounting**

A lessor's accounting first depends on whether the lessor elects the sales and other similar taxes practical expedient (see paragraphs 4.2.200 – 4.2.210).

#### **Lessor elects the practical expedient – in-scope taxes**

The lessor accounts for all 'in-scope' taxes (see paragraphs 4.2.170 – 4.2.180) as lessee costs, rather than evaluating whether each tax in each taxing jurisdiction is a lessee or a lessor cost; this is regardless of who remits payment of the tax to the taxing authority.

This means that the tax and the lessee's payment thereof will be presented net of each other (i.e. with zero effect) in the lessor's income statement.

#### **Lessor elects the practical expedient – out-of-scope taxes**

Even if a lessor has elected the sales and other similar taxes practical expedient, it follows the guidance for a lessor that has not elected the practical expedient (see below) for out-of-scope taxes. Paragraphs 4.2.170-4.2.180 address in-scope and out-of-scope taxes.

#### **Lessor does not elect the practical expedient**

The first step for a lessor that does not elect the practical expedient is to determine whether the applicable tax is a lessee or a lessor cost. This approach also applies to taxes that are outside the scope of the practical expedient regardless of the lessor's election.

The tax is a lessee cost if the lessee remits the tax directly to the relevant taxing authority. In contrast, the tax is a lessor cost if the lessor remits the tax to the taxing authority and receives reimbursement for the tax amount from the lessee (see Question 7.3.60). It does not matter which party (lessee or lessor) is primarily obligated for the tax. [842-10-15-40A]

### If the tax is a lessee cost

The lessor's accounting for the tax and the lessee's payment thereof is the same as for in-scope taxes for a lessor that elects the sales and other similar taxes practical expedient. The tax and the lessee's payment thereof will be presented net of each other (i.e. with zero effect) in the lessor's income statement.

### If the tax is a lessor cost

The lessor's accounting for the tax will depend on when the tax is incurred and whether the lessor is a manufacturer or dealer. The following table summarizes the accounting that we believe applies.

Tax is incurred:		
Over the lease term	At or before lease commencement <i>(manufacturer or dealer lessor)</i>	At or before lease commencement ( <i>non-manufacturer or dealer lessor</i> )
The lessor should follow the guidance on lessee payments of lessor costs in paragraph 7.3.190	<ul style="list-style-type: none"> <li>— <b>Operating lease.</b> The tax is capitalized as part of the cost basis of the underlying asset. It should be accounted for in the same way as the remainder of the asset's cost over its useful life.</li> <li>— <b>Sales-type or direct financing lease.</b> The tax should be expensed at lease commencement because it is part of the cost basis of the asset (which will be derecognized), but cannot be included as part of the lessor's net investment in the lease.</li> </ul>	<ul style="list-style-type: none"> <li>— <b>Operating lease.</b> Same as for manufacturer or dealer lessors.</li> <li>— <b>Sales-type or direct financing lease.</b> The tax cost is included in the fair value of the underlying asset (see paragraph 7.3.41), and therefore capitalized as part of the net investment in the lease. As a result, it will be recognized as a reduction to interest income earned on the lease over the lease term in the same manner as an initial direct cost.</li> </ul>



### Question 4.2.70

#### Refundable and nonrefundable VAT

### What is the appropriate lessee and lessor accounting for refundable and nonrefundable VAT?

**Background:** A value-added tax (VAT) is a type of consumption tax that is placed on a product whenever value is added at a stage of production and at the point of retail sale.

VAT is charged based on the value added at each stage of production. VAT is assessed and collected on the value of goods or services that have been provided every time there is a transaction (sale/purchase). The seller charges VAT to the buyer, and the seller pays this VAT to the government. If, however, the purchasers are not the end users, but the goods or services purchased are costs to their business, the tax they have paid for such purchases can be deducted from the amounts they charge to their customers when the tax is remitted to the government. The government receives only the difference – i.e. VAT is a tax paid on the gross margin of each transaction, by each participant in the sales chain.

The characteristics of VAT vary by jurisdiction. However, assume the following general characteristics for purposes of this discussion.

- The tax applies to goods and services consumed in the applicable jurisdiction.
- Either the lessor or the lessee may be the primary obligor to the taxing authority for the VAT. For example, in many cases the lessor is responsible for ensuring that the VAT is remitted – i.e. it is the lessor that the taxing authority will take action against if the VAT is not paid. In other cases the taxing authority will hold the lessee responsible for ensuring that the VAT is remitted.
- For purchases of goods and services to which VAT applies, the customer is obligated to pay VAT to the supplier, and the supplier is obligated to collect the VAT and remit it to the taxing authority.
- Businesses will charge tax on their sales and usually will be able to recover the tax paid on goods and services used in the course of doing business (input tax credits) – i.e. the amounts are refundable. However, in some cases the customer cannot recover the VAT paid – i.e. the VAT is nonrefundable. This can occur, for example, because the customer's revenue-generating activities are not subject to VAT.
- In leasing transactions, VAT is typically incurred over the lease term, consistent with how VAT is incurred on service transactions. However, if the lease is akin to a sale of the underlying asset, the VAT generally is incurred at lease commencement.

**Interpretive response:** We believe the accounting for VAT is substantially the same as that for sales taxes. Therefore, entities that incur VAT and make or receive VAT payments in connection with a lease on a *nonrefundable* basis should follow the guidance in Question 4.2.60.

#### **VAT is refundable**

If the VAT is refundable, the lessee's payment of the VAT will neither trigger income statement recognition by the lessee, nor be capitalized as part of the cost of the ROU asset. This is because the VAT is not truly a cost of the lessee if it will be refunded. The VAT should be accounted for as it would any other refundable payment.

For the lessor, lessee VAT payments to the lessor that will be refunded to the lessee should be presented net in the lessor's income statement – i.e. no lease

revenue or tax expense. This is regardless of whether the lessor elects the sales and other similar taxes practical expedient.



## Comparison to legacy US GAAP

### **Accounting for property taxes and insurance**

#### ***Finance (sales-type/direct financing leases)***

4.2.230 Under Topic 840, executory costs for property taxes or insurance (whether fixed or variable) were excluded from the measurement of the capital lease asset and capital lease obligation (lessees) and the net investment in the lease (lessors). [840-10-25-1(d), 840-30-30-1 – 30-2]

4.2.240 In contrast, under Topic 842, lessee payments of lessor property taxes or insurance, if fixed, are part of the ‘consideration in the contract’. Consequently, all or a portion (if the contract includes one or more non-lease components) of such payments are allocated to the lease component(s) of the contract, considered ‘lease payments’, and included in the measurement of (1) the lessee’s ROU asset and finance lease liability and (2) the lessor’s net investment in the lease.

4.2.250 As a result, the lease assets and lease liabilities for lessees and lessors may be larger in gross finance (sales-type/direct financing) lease scenarios under Topic 842 than they were under Topic 840; barring other measurement differences such as with respect to residual value guarantees, which will generally result in larger lease assets and liabilities under Topic 840 (see section 5.4.6).

#### ***Operating leases***

4.2.260 Under Topic 840, ‘minimum rental payments’ was not a defined term. As discussed in Questions 13A.3.10 and 13B.3.10, some entities interpreted the minimum rental payments to include fixed payments required by the lease contract for executory costs such as property taxes and insurance, while others interpreted minimum rental payments to exclude those amounts. [840-10-25-5(b), 25-6]

4.2.270 Topic 842 treats lessee payments of lessor property taxes or insurance in the same manner regardless of the classification of the lease (see paragraph 4.2.140 for finance (and sales-type/direct financing) leases). Consequently, ignoring other potential effects (e.g. resulting from differences in the accounting for residual value guarantees – see section 5.4.6), the lease payments under Topic 842 will differ from the minimum rental payments. That is, ignoring other potential differences:

- If the lessee excluded fixed executory costs from minimum rental payments (see Questions 13A.3.10 and 13B.3.10), the lease payments under Topic 842 will be greater than the minimum rental payments.
- If the lessee included fixed executory costs in minimum rental payments, the lease payments under Topic 842 will be less than the minimum rental payments when there are non-lease components of the contract.

### **Lease classification**

4.2.280 Under Topic 840, lessee payments of executory costs for property taxes or insurance, if fixed (e.g. in a gross lease), were excluded from the 'minimum lease payments' for purposes of determining lease classification – i.e. in performing the 90 percent test. [840-10-25-1(d)]

4.2.290 In contrast, under Topic 842, the portion of those payments that are considered 'lease payments' are not excluded from the lease classification test – they are included when determining whether the present value of the sum of the lease payments and any residual value guaranteed by the lessee (or a third party) 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. Consequently, a lease with fixed payments for property taxes or insurance may meet the lease payments criterion in paragraph 842-10-25-2(d) or paragraph 842-10-25-3(b)(1) even though it would not have met the 90 percent test in paragraph 840-10-25-1(d).

## 4.3 Step 3: Measure the consideration in the contract



### **Excerpt from ASC 842-10**

#### **30 Initial Measurement**

##### **General**

> Initial Measurement of the Lease Payments

**30-5** At the **commencement date**, the **lease payments** shall consist of the following payments relating to the use of the **underlying asset** during the **lease term**:

- a. Fixed payments, including in substance fixed payments, less any lease incentives paid or payable to the **lessee** (see paragraphs 842-10-55-30 through 55-31).
- b. **Variable lease payments** that depend on an index or a rate (such as the Consumer Price Index or a market interest rate), initially measured using the index or rate at the commencement date.
- c. The exercise price of an option to purchase the underlying asset if the lessee is reasonably certain to exercise that option (assessed considering the factors in paragraph 842-10-55-26).
- d. Payments for **penalties** for terminating the **lease** if the lease term (as determined in accordance with paragraph 842-10-30-1) reflects the lessee exercising an option to terminate the lease.
- e. Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction. However, such fees shall not be included in the **fair value** of the underlying asset for purposes of applying paragraph 842-10-25-2(d).
- f. For a lessee only, amounts **probable** of being owed by the lessee under **residual value guarantees** (see paragraphs 842-10-55-34 through 55-36).

## 15 Scope and Scope Exceptions

### General

> Separating Components of a Contract

- > Lessee

**15-35** The consideration in the contract for a lessee includes all of the payments described in paragraph 842-10-30-5, as well as all of the following payments that will be made during the **lease term**:

- a. Any fixed payments (for example, monthly service charges) or in substance fixed payments, less any incentives paid or payable to the lessee, other than those included in paragraph 842-10-30-5
- b. Any other variable payments that depend on an index or a rate, initially measured using the index or rate at the **commencement date**.

## 15 Scope and Scope Exceptions

### General

> Separating Components of a Contract

- > Lessor

**15-39** The consideration in the contract for a lessor includes all of the amounts described in paragraph 842-10-15-35 and any other variable payment amounts that would be included in the transaction price in accordance with the guidance on variable consideration in Topic 606 on revenue from contracts with customers that specifically relates to either of the following:

- a. The lessor's efforts to transfer one or more goods or services that are not leases
- b. An outcome from transferring one or more goods or services that are not leases.

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

**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.

**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).

## 55 Implementation Guidance and Illustrations

### General

- > Illustrations
  - > Illustrations of Allocating Consideration to Components of a Contract
  - • > 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.

	Standalone Price	Relative Standalone Price
<b>Lease</b>	\$ 285,000	\$ 259,091
<b>Maintenance</b>	45,000	40,909
	<hr/> <hr/>	<hr/> <hr/>
	\$ 330,000	\$ 300,000

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

**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.

	Standalone Price	Relative Standalone Price
<b>Lease</b>	\$ 285,000	\$ 277,227
<b>Maintenance</b>	<hr/> 45,000	<hr/> 43,773
	<hr/> \$ 330,000	<hr/> \$ 321,000

**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.

• • • > 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:

- 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).
- 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.

### 4.3.1 Lessee

4.3.10 The starting point for a lessee measuring the consideration in the contract is the defined payments in paragraph 842-10-30-5 relating to the use of the underlying asset (see section 5.4), which are then adjusted as follows.  
[842-10-15-35]

#### Payments related to the use of the underlying asset



#### Other fixed or in-substance fixed payments



#### Other variable payments that depend on an index or rate<sup>1</sup>



#### Incentives paid or payable to the lessee<sup>2</sup>



#### Consideration in the contract (lessee)

Notes:

1. The payments are calculated using the commencement date index or rate.
2. Other than those included in paragraph 842-10-30-5.

4.3.20 As this calculation illustrates, not all payments contemplated in the contract are included. For example, a fixed monthly service charge is included, but a variable monthly service charge that does not depend on an index or rate is not included. The following concepts that apply to determining the lease payments also apply in determining whether other payments should be included in the consideration in the contract.

- Determining whether a payment is in-substance fixed.
- Determining whether a payment is based on an index or a rate and calculating the amount to include in the calculation.
- The approach to, and logic for, adjusting for incentives.

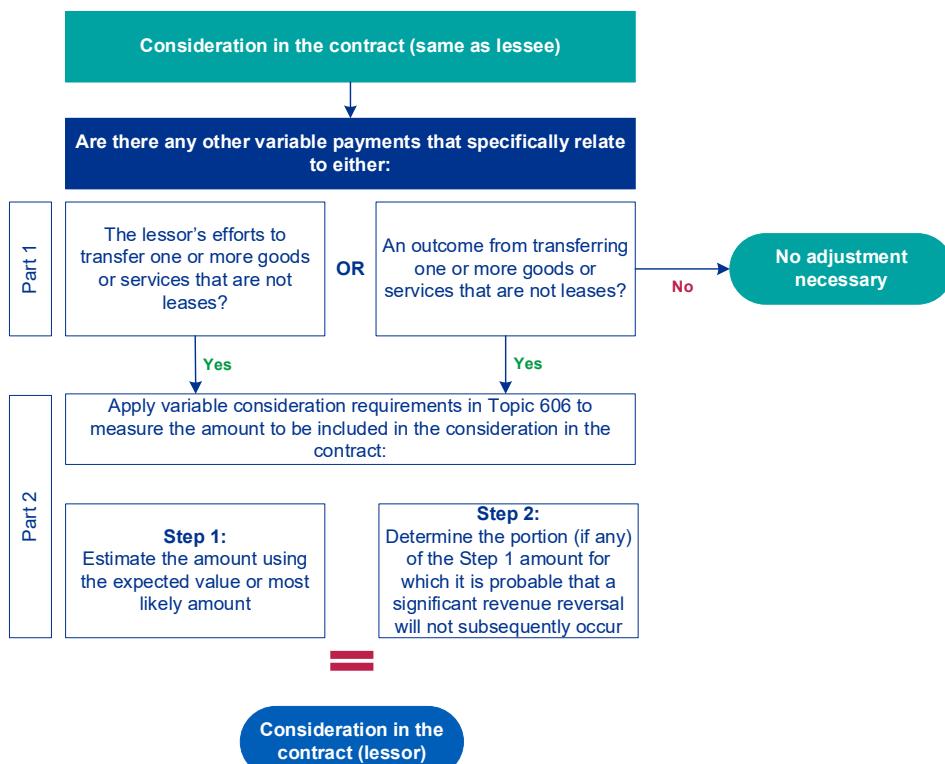
See section 5.4 for further guidance on determining lease payments.

4.3.30 A payment made by a lessor to a lessee is an incentive, reducing the consideration in the contract, unless the payment is for a distinct good or service provided by the lessee to the lessor – e.g. for construction of, or managing the construction of, the lessor's asset. In addition, even if the lessee provides a distinct good or service to the lessor, any amount of the lessor's payment in excess of the fair value of the distinct good(s) or service(s) provided is an incentive. [842-10-15-35(a), 606-10-32-25 – 32-26]

4.3.40 Once the amount of consideration in the contract has been measured, it is allocated to the lease and non-lease components of the contract in Step 4 (see section 4.4). The accounting for amounts payable under the contract that are not included in the consideration in the contract is discussed in section 4.4.3. [842-10-15-30]

## 4.3.2 Lessor

4.3.50 As a starting point, a lessor measures the consideration in the contract in the same way as a lessee. However, further adjustments are made as follows. [842-10-15-38 – 15-39, 606-10-32-8 – 32-14]

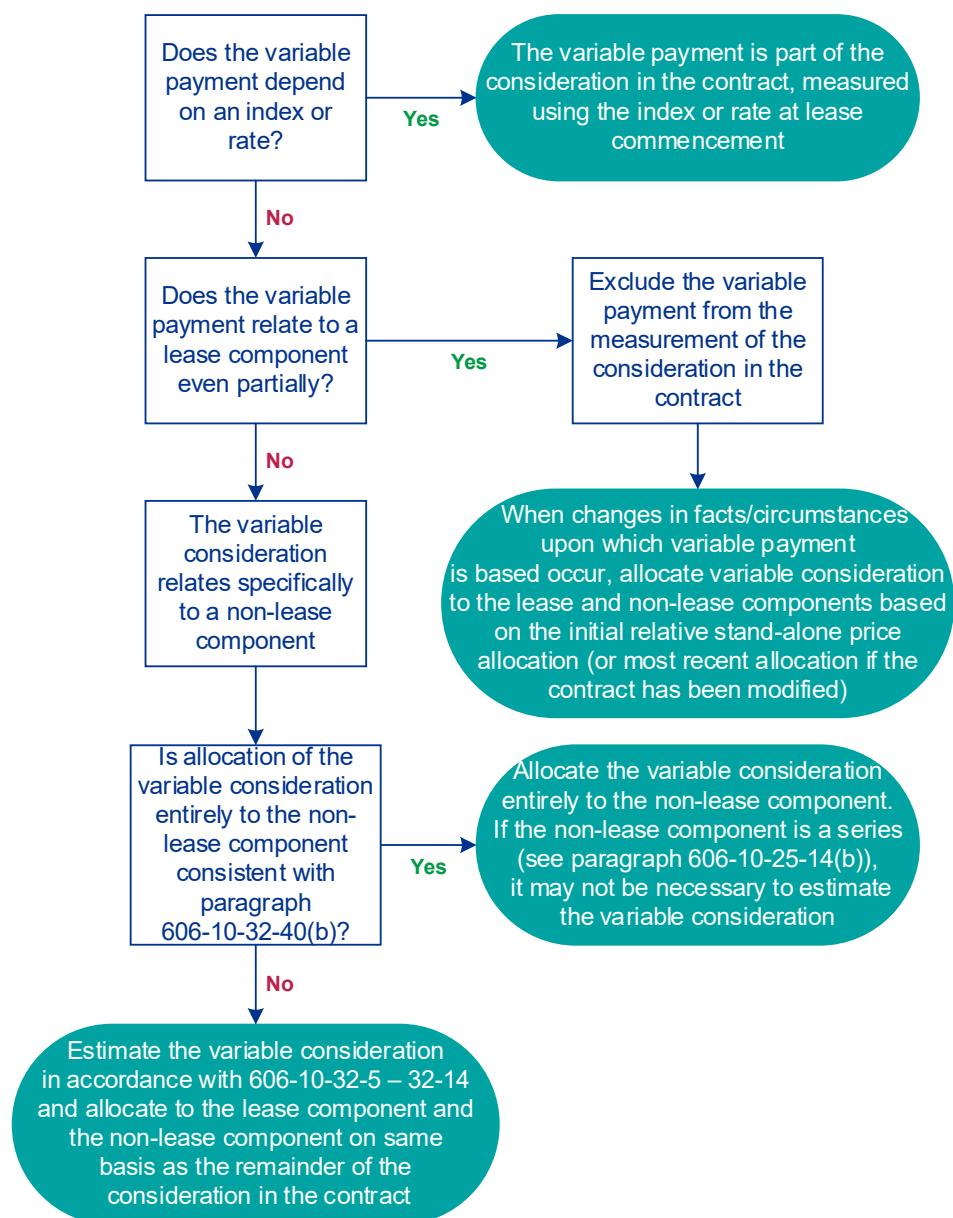


4.3.60 In considering whether any variable payments should be included in the consideration in the contract, the objective in Part 1 of the above flowchart is to establish whether such payments vary solely on the performance of the non-lease component(s); for example, do the payments depend solely on the lessor's performance of non-lease services or the delivery or quality of

consumables to be used with the leased asset? This is explored in Example 4.3.10. [842-10-55-153 – 55-156]

4.3.70 The following flowchart summarizes the *lessor's* process for evaluating variable payments in the contract when either:

- the lessor has elected to separate lease and non-lease components – i.e. has *not* elected the practical expedient outlined in paragraphs 4.4.51 – 4.4.56; or
- the contract contains at least one lease component (including a combined lease component) and one or more non-lease components that do not qualify to be combined with the lease component based on the criteria in paragraph 4.4.51.



4.3.75 If a lessor has elected to not separate lease and non-lease components that qualify for the non-separation practical expedient outlined in paragraphs 4.4.51 – 4.4.56, and, as a result, the contract contains *only* (1) lease components or (2) non-lease performance obligations accounted for under Topic 606, the model flowcharted in the preceding paragraph does not apply. Rather, if application of the practical expedient results in only: [842-10-15-42B, ASU 2018-11.BC33, 842-10-15-40]

- **Lease components**, all variable payments that do not depend on an index or rate (and are not in-substance fixed payments) are excluded from the measurement of the consideration in the contract, regardless of whether there are variable payments that relate specifically to a non-lease element of the combined component (or an outcome from transferring a non-lease element that is part of the combined component).
- **Topic 606 performance obligations**, then all variable payments are accounted for in accordance with the variable consideration transaction price guidance in Topic 606 (see chapter 5 of KPMG Handbook, [Revenue recognition](#)), even if those variable payments relate (wholly or partially) to the lease element of the combined performance obligation (component). [606-10-32-5 – 32-14]



### Question 4.3.10

#### Measuring consideration in a contract with variable payments

#### What types of variable payments are excluded from the consideration in the contract?

**Interpretive response:** The following types of variable payments are *excluded* from the consideration in the contract.

##### Lessee

- Variable payments that do not depend on an index or rate – e.g. property tax and insurance reimbursements and rental payments based on the use of the underlying asset. [842-10-15-35]

##### Lessor

- Variable payments specifically or partially related to a lease component(s) that do not depend on an index or rate – e.g. property tax and insurance reimbursements and rental payments based on use of the underlying asset. This includes all variable payments that relate to a combined operating lease component (see paragraph 4.3.75). [842-10-15-40]
- Variable payments that, while specifically related to one or more non-lease components, if included in the consideration in the contract, give rise to a more-than-remote possibility that the lessor will have a significant revenue reversal (see Question 4.5.10).



### Question 4.3.20

#### Variable payments for CAM in a net lease

**Are variable payments for CAM included in the consideration in the contract when amounts that will be billed are unknown at lease commencement? If so, how are those amounts measured?**

**Interpretive response:**

**Lessee**

No. Expected variable payments for CAM during the lease term, even if virtually certain to be incurred, are not included in the consideration in the contract.  
[842-10-15-35]

**Lessor**

Yes. The lessor's estimate of variable CAM charges is included in the consideration in the contract, unless the CAM is part of a combined operating lease component (see paragraphs 4.4.53 – 4.4.55). This is because variable CAM charges specifically relate to the CAM non-lease component. The lessor's estimate of CAM charges to which it will be entitled during the lease term is determined based on the guidance in paragraphs 606-10-32-5 – 32-14 – i.e. based on a most likely amount or expected value method estimate, subject to the constraint on variable consideration. [842-10-15-39]

Under some lease contracts the lessor may bill for other non-lease items together with, or characterized as, CAM that are not part of CAM (see discussion in Question 4.2.20). For example, utilities for a retail or office space may be provided to the lessee by the lessor and billed together with, or as part of, CAM. In the case of non-lease goods or services other than CAM such as utilities, variable payments that specifically relate to those items will follow the same requirements as for variable payments that are for CAM.

However, lessors should ensure they do not include in their estimate of variable CAM charges variable payments for items bundled together with CAM that relate to either lease components or costs that are not components at all (e.g. property taxes or building insurance), which sometimes may be billed to the lessee as part of total charges described as CAM but represent discrete, separately identifiable, components of those total charges. Such amounts are not variable payments for the transfer of a non-lease good or service and therefore are not estimated or included in the consideration in the contract (see Question 4.3.10).

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4.3.80 Once the consideration in the contract has been measured, it is allocated to the lease and non-lease components of the contract in Step 4, unless the lessee or lessor non-separation practical expedient is being applied (see section 4.4). The accounting for amounts payable under the contract that are not included in consideration is discussed in section 4.4.3. [842-10-15-30]



### Example 4.3.10

#### **Measuring the consideration in the contract – variable payments**

##### **Scenario 1: Variable payments do not specifically relate to non-lease component**

Lessee LE and Lessor LR enter into a three-year lease of equipment that includes maintenance services on the equipment throughout the lease term. LE will pay LR:

- a fixed payment of \$110,000 per year; and
- a variable payment of \$7,700 each year that the equipment is operational for a minimum number of hours at a specified level of productivity – i.e. the equipment is not malfunctioning or inoperable.

##### **Lessee**

LE does not include the variable payments in the consideration in the contract. This is because the variable payments do not depend on an index or rate (and are not in-substance fixed).

Therefore, the consideration in the contract is \$330,000 ( $\$110,000 \times 3$ ).

##### **Lessor**

LR starts with the amount of consideration determined in the same way as LE (i.e. \$330,000).

Next, LR considers the link between the variable payments of \$23,100 ( $\$7,700 \times 3$ ) and the performance of the maintenance services. LR concludes that the variable payments do not specifically relate to performance of the maintenance services. The quality and condition of the leased equipment also substantively affects whether LR will earn the variable amounts.

Therefore, the variable payments are excluded, and the consideration in the contract is \$330,000. The potential \$23,100 in variable payments will be recognized when earned.

This scenario is continued in Example 4.4.30, Scenario 1, which illustrates how LR allocates the consideration in the contract (Step 4 – see section 4.4.2).

##### **Scenario 2: Variable payments specifically relate to non-lease component – no amounts constrained**

Changing the facts of Scenario 1, the maintenance services are highly specialized, and no entity would expect the leased equipment to meet the specified performance metrics without the related maintenance services.

##### **Lessee**

This change in fact pattern makes no difference for LE. The consideration in the contract remains at \$330,000.

##### **Lessor (does not elect the practical expedient to not separate the lease and maintenance components)**

LR starts with the amount of consideration determined in the same way as LE (i.e. \$330,000).

Next, LR considers the link between the variable payments of \$23,100 and the performance of the maintenance services. LR concludes that the variable payments relate specifically to an outcome dependent on LR's satisfactory performance of its maintenance services. This is because the maintenance services are highly specialized and critical to the operation of the equipment.

Next, LR applies the variable consideration requirements in Topic 606 to calculate the amount that should be included in the consideration in the contract:

- a. LR estimates that the amount to which it expects to be entitled is \$23,100.
- b. LR concludes that it is probable that including that amount in the transaction price for the maintenance services will not result in a significant revenue reversal when the uncertainty is resolved.

Therefore, the consideration in the contract is \$353,100 (\$330,000 + \$23,100).

This scenario is continued in Example 4.4.30, Scenario 2, which illustrates how LR allocates the consideration in the contract (Step 4 – see section 4.4.2).

**Lessor (elects and qualifies for the practical expedient to not separate the lease and maintenance components)**

Because the maintenance services are not the predominant element of the combined lease/maintenance services component (i.e. LE would ascribe more value to the lease element), the combined component is accounted for as an operating lease. Therefore, the consideration in the contract is the same as for LE (see paragraph 4.3.75).

**Scenario 3: Variable payments specifically relate to non-lease component – amounts partially constrained**

Changing the facts of Scenario 2, LE will pay LR:

- a fixed payment of \$102,700 per year; and
- a variable payment of \$15,000 each year that the equipment is operational for a minimum number of hours at a specified level of productivity – i.e. the equipment is not malfunctioning or inoperable.

**Lessee**

LE does not include the variable payments in the consideration in the contract. This is because the payments do not depend on an index or rate.

Therefore, the consideration in the contract is \$308,100 (\$102,700 × 3).

**Lessor (does not elect the practical expedient to not separate the lease and maintenance components)**

LR starts with the amount of consideration determined in the same way as LE (\$308,100).

Next, LR considers the link between the variable payments of \$45,000 (\$15,000 × 3) and the performance of the maintenance services. As in Scenario 2, LR concludes that the variable payments relate specifically to an outcome dependent on LR's satisfactory performance of its maintenance services.

Next, LR applies the variable consideration requirements in Topic 606 to calculate the amount that should be included in the consideration in the contract.

- LR estimates that the amount to which it expects to be entitled is \$45,000.
- LR concludes that only \$30,000 of that amount is probable of not resulting in a significant revenue reversal when the uncertainty is resolved.

Therefore, the consideration in the contract is \$338,100 (\$308,100 + \$30,000).

This scenario is continued in Example 4.4.30, Scenario 3, which illustrates how LR allocates the consideration in the contract (Step 4 – see section 4.4.2).

***Lessor (elects and qualifies for the practical expedient to not separate the lease and maintenance components)***

The analysis and the conclusion are the same as for Scenario 2.

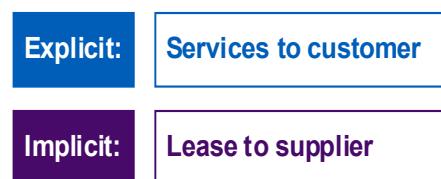


**Is a ‘free’ lease granted to a supplier or a service provider by the customer noncash consideration for the vendor’s goods or services?**

**Background:** Consider a scenario in which a supplier is a service provider and provides a service to a customer (owner and operator of a building) that involves the placement of equipment in a physically distinct portion of the customer’s building. The equipment will also benefit parties other than the customer, such that the customer does not have the right to obtain substantially all of the economic benefits from use of the equipment. Therefore, the equipment is not being leased to the customer.

Further, neither the customer nor any other party can use the identified space in which the equipment is installed. Assume that on the basis of this and other facts, the supplier’s use of the physically distinct portion of the customer’s building meets the definition of a lease of the identified space from the customer to the supplier.

Therefore, there are two elements to the arrangement.



The customer will pay the supplier a contractually stipulated monthly service charge (which may be fixed, or variable based on usage of the service). There is no stated consideration for the lease between the customer and the supplier.

The service period is three years. The question, in this scenario, is whether, as a result of the property lease:

- the supplier should account for the property lease as additional consideration for the service, and recognize an ROU asset and a lease liability; and
- the customer should recognize lease income, along with corresponding additional service expense.

**Interpretive response:** Yes. If, as in the background, a supplier is obtaining a lease from a customer for no stated consideration, we believe the fair value of the lease should be considered additional, noncash, consideration for the vendor's goods or services. The transaction price for the goods or services will be the sum of the cash consideration plus the fair value of the noncash consideration (i.e. the fair value of the lease). The fair value of the lease will drive the initial measurement for the supplier (lessee) of the ROU asset and lease liability.

Correspondingly, the customer (lessor) will recognize lease income based on the fair value of the lease at contract inception, with an offsetting increase to the cost of the goods or services from the supplier (lessee). The cost of the goods or services to the customer will, therefore, exceed the customer's cash payments for those goods or services, just as the supplier's revenue will exceed the customer's cash payments for the goods or services. This would be the case even if the stated consideration in the service contract (i.e. which excludes the embedded lease) is consistent with the observable stand-alone selling price for the goods and/or services the supplier is providing.



### Example 4.3.20

#### 'Free lease' granted to a supplier

Consider the fact pattern included in the background to Question 4.3.30. In addition, the following facts are relevant.

Service charge in the contract:	\$10,000 per month (\$360,000 for the three-year contract)
Fair value of the lease:	\$1,000 per month (\$36,000 for the three-year contract)
Supplier's (lessee's) incremental borrowing rate:	5%
Lease classification:	Operating

Based on the guidance in Topic 606, the services are a performance obligation satisfied over time and a time-elapsed measure of progress for the services is appropriate (see chapter 7 of KPMG Handbook, [Revenue recognition](#)).

#### Supplier (lessee)

Based on these facts and the interpretive response above, Supplier's accounting is as follows. Assume that despite the fact that the right of use (i.e.

the noncash consideration) is provided up-front, while the services will be provided over three years, there is not a significant financing component in the contract that Supplier must address in its revenue recognition under Topic 606.

- At lease commencement (i.e. the start of the three-year service period), Supplier recognizes a lease liability of \$32,679 representing the total consideration for the lease ( $\$1,000 \times 36$  months), discounted at Supplier's incremental borrowing rate.
- At lease commencement, Supplier recognizes an ROU asset equal to the lease liability because there are no initial direct costs, lease prepayments or lease incentives.
- Supplier recognizes annual lease expense of \$12,000 in each of the three years.
- Supplier recognizes the \$396,000 transaction price (\$360,000 in cash + \$36,000 fair value of the noncash lease consideration) on a straight-line basis (i.e. using a time-based measure of progress) over the three-year services period.

#### **Customer (lessor)**

Customer (property owner) recognizes annual lease income of \$12,000 (the opposite of Supplier's \$12,000 of lease expense) and annual service expense of \$132,000 as the services are provided by Supplier. Because the lease is an operating lease, Customer does not derecognize any portion of the building that it is leasing to Supplier.



#### Question 4.3.40

#### **Timing of measurement**

**How should an entity measure the consideration in the contract if the lessor provides (1) a non-lease component before lease commencement and/or (2) two or more lease components with different commencement dates?**

**Interpretive response:** The consideration in the contract for both lessees and lessors starts with the payments relating to the use of the underlying asset. Those payments are measured at the lease commencement date (see chapter 5).

Topic 842 does not provide guidance about how an entity measures the consideration in the contract if the lessor provides a non-lease component – i.e. other goods or services – before commencement of the lease.

For example, a lessor agrees to lease a lessee a new piece of IT equipment, the term of which commences in two months when the requested piece of equipment can be delivered and made available to the lessee. The lease includes a lessee renewal option, a lessee purchase option, and a lessee provided residual value guarantee. In addition to the lease, the lessor also

agrees to immediately begin maintaining the lessee's existing IT equipment that will remain in service together with the new leased equipment.

The lessee should begin recognizing expense, and the lessor income, for the maintenance services being provided; however, it is unclear what amount the parties should recognize because the payments relating to the use of the underlying asset are measured at lease commencement. The assessments of whether the lessee is reasonably certain to exercise the renewal and purchase options, or if it is probable that the lessee will owe an amount under the residual value guarantee, are based on facts and circumstances at lease commencement. [842-10-15-35, 30-5]

This timing issue could also arise for a contract that includes only lease components, but for which the commencement date of those leases differs. For example, a lessee leases two pieces of equipment and each lease is a separate lease component. The lessee and the lessor are required to allocate the consideration in the contract to those two separate lease components, and will begin recognizing lease cost or lease income upon commencement of the first lease. However, consistent with the previous lease and non-lease component example, the parties cannot measure the total consideration in the contract before commencement of the second lease.

In the absence of guidance in Topic 842 to resolve this issue, we believe an entity should make a preliminary estimate of the consideration in the contract. This includes doing all of the following at the point in time that the parties need to commence their accounting:

- measuring any variable lease payments that depend on an index or rate based on the index or rate at that point in time;
- assessing the likelihood of lessee option exercises (renewal, termination and/or purchase options) based on the then-current facts and circumstances; and
- assessing amounts probable of being owed under a residual value guarantee based on the then-current facts and circumstances.

However, because Topic 842 requires measurement as of the commencement date, we believe an entity should true up this initial accounting at the commencement date (or the final commencement date in the multiple separate lease components example).



## Observation

### Differences between Topic 842 and Topic 606 for lessors

4.3.90 The accounting for variable payments by lessors under Topic 842 is different from how variable consideration is accounted for under Topic 606 by vendors/suppliers.

4.3.100 Therefore, the Board decided that guidance was necessary for lessors to navigate the differences. The guidance is intended to help clarify whether and, if so, when the consideration in the contract for a lessor includes variable

consideration (subject to the constraint in Topic 606) – Step 2 of Part 2 in the flowchart in paragraph 4.3.50. [ASU 2016-02.BC161-BC163]

4.3.110 Paragraph 606-10-15-4 states that if other Topics (e.g. Topic 842) provide separation and measurement guidance, an entity applies that guidance first. The entity then excludes amounts allocated to items covered by the other Topics from the Topic 606 transaction price that applies to the performance obligations within the scope of Topic 606. In the context of Topic 842, this means that a lessor separates lease from non-lease components (as required by Topic 842), measures the consideration in the contract in accordance with Topic 842, and allocates consideration to the lease and non-lease components in accordance with Topic 842.

4.3.120 As a result, the consideration in the contract allocated to a non-lease (e.g. service) component in the scope of Topic 606 may differ from the transaction price that would be determined for that component if it were not associated with a lease. Consequently, applying the separation and measurement guidance in Topic 842 to a non-lease component in the scope of Topic 606 may result in an entity accounting for the same good or service obligation to a customer differently depending solely on whether it is (or is not) provided in conjunction with a lease. [842-10-55-150 – 55-156, 606-10-15-4, ASU 2016-02.BC163]

4.3.130 Example 4.4.30 (Scenarios 1 and 2) illustrates this effect. Lessors will not recognize variable amounts that are partially, but not solely, attributable to a non-lease (e.g. service) component as income before the changes in facts and circumstances upon which the amount of the payments is based has occurred. In contrast, the entity's revenue recognition might differ for that service component if it were being provided separately or in conjunction with a sold (rather than leased) piece of equipment because revenue attributable to the service may be recognized under Topic 606 before the change in facts and circumstances upon which the amount of the payments is based has occurred.



## Comparison to legacy US GAAP

### **Lessor accounting for variable payments affected by definition of consideration in the contract**

4.3.140 Under Topic 840, lessors recognized *all* contingent payments in the same manner as lessors will recognize variable payments that relate at least partially to a lease component under Topic 842 (see paragraph 4.3.130). Therefore, while most variable payments in lease contracts will continue to be recognized in a manner consistent with how they were recognized under Topic 840, the requirement for lessors to estimate variable payments and include them in the consideration in the contract in some cases – i.e. when they relate solely to a non-lease component – could affect the timing and/or pattern of income recognition for lessors. [SAB Topic 13.A]

4.3.150 For example, if a lessor applying Topic 842 includes a performance bonus that it expects to earn from providing a service to the lessee in the consideration in the contract, it will generally recognize at least a portion of that

amount as income over the period the service is provided even if the performance bonus is not yet earned. In contrast, under Topic 840, that same lessor generally would not recognize the performance bonus until the performance metric triggering the bonus was met. [840-10-25-4, 840-20-25-2, 840-30-25-3]

## 4.4 Step 4: Separate and allocate consideration between the lease and non-lease components

### 4.4.1 Allocate the consideration in the contract



#### Excerpt from ASC 842-10

##### 15 Scope and Scope Exceptions

> Separating Components of a Contract

- > Lessee

**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.

**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.

- > Lessor

**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.

**15-42A** 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 25-3A.

**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.

## 55 Implementation Guidance and Illustrations

### General

> Illustrations

- > Illustrations of Allocating Consideration to Components of a Contract
- • > 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:

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

**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 services for each piece of leased equipment are distinct and therefore separate performance obligations, resulting in the conclusion that there are three separate lease components and three separate nonlease components (that is, three maintenance service performance obligations).

**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.

**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.

	<b>Lease</b>	<b>Maintenance</b>
<b>Bulldozer</b>	\$ 200,000	\$ 50,000
<b>Truck</b>	120,000	20,000
<b>Crane</b>	240,000	70,000
	<b>\$ 560,000</b>	<b>\$ 140,000</b>

**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.

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

• • • > 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.

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

4.4.10 Non-lease components are separated from related lease components, unless the applicable lessee or lessor non-separation practical expedient applies. Lease components are accounted for under Topic 842; non-lease components are accounted for under other applicable US GAAP. [842-10-15-31]

4.4.20 When the consideration in the contract is allocated between the lease and non-lease components of a contract, different methodologies apply to the lessee and the lessor. [842-10-15-33, 15-38]

	<b>Lessee</b>	<b>Lessor</b>
When there is an observable stand-alone (selling) price for each component:	Separate and allocate based on the relative stand-alone price of components.	Allocate following the Topic 606 transaction price allocation guidance – i.e. generally on a relative stand-alone selling price basis.
When there is not an observable stand-alone (selling) price for some or all components:	Estimate the stand-alone price, maximizing using observable information.	
<b>Remember:</b>  Activities (or costs of the lessor) that do not transfer a good or service to the lessee are not components of the contract (see section 4.2). Therefore, no consideration is allocated to such items.		

## ***Practical expedients to not separate lease and related non-lease components***

### **Lessee**

4.4.30 As a practical expedient, a lessee may elect not to separate the non-lease components of a contract from the lease component to which they relate. This means that the components will be treated as a single lease component. For example, in a lease of a machine with the lessor responsible for machine maintenance, the lessee may account for a single lease component – i.e. the payments that would otherwise be attributed to the maintenance will be accounted for as lease payments and included in the measurement of the lessee's ROU asset and lease liability. Including the payments for non-lease goods or services in the lease payments may affect lease classification – e.g. the inclusion of those payments in the lease payments may result in 'failing' the present value lease classification test (see section 6.2). [842-10-15-37]

4.4.40 Combining a non-lease component with a lease component will generally result in straight-line recognition of the cost for the non-lease component. This pattern of expense recognition might differ in some cases from the pattern of expense recognition that would apply if the non-lease component were accounted for separately from the lease.

4.4.50 A lessee elects this practical expedient by class of underlying asset – e.g. office equipment, automobiles, office space. [842-10-15-37]

### **Lessor**

4.4.51 As a practical expedient, a lessor may elect not to separate non-lease components that would be within the scope of Topic 606 if accounted for separately from associated lease components when two specific criteria are met. Those criteria are: [842-10-15-42A]

- The timing and pattern of transfer to the lessee of the lease component and the non-lease component(s) associated with that lease component are the same; and
- The lease component, if accounted for separately, would be classified as an operating lease in accordance with paragraphs 842-10-25-2 through 25-3A.

4.4.52 If the practical expedient has been elected and a contract includes multiple non-lease components—one or more that meet(s) the timing and pattern of transfer criterion and one or more that does(not) meet the criterion—the lessor combines the non-lease component(s) that meet the criterion with the lease component and separates any non-lease components that do not. [842-10-15-42C]

4.4.53 If the non-lease component(s) is (are) the predominant component(s) of the combined component, the lessor should account for the combined component under Topic 606 as a single Topic 606 performance obligation, rather than the leases guidance in Topic 842. In those cases, the lessor: [842-10-15-42B]

- uses the same measure of progress for the combined Topic 606 component as it used when determining eligibility for combination of the lease and non-lease component(s) in accordance with paragraph 842-10-15-42A(a) (generally, time elapsed – see Question 4.4.13); and

- accounts for all variable payments related to any good or service, including the lease, that is part of the combined Topic 606 performance obligation in accordance with the guidance on variable consideration in Topic 606 (see paragraph 4.3.75).

4.4.54 In determining whether the non-lease component(s) is (are) predominant, the lessor should consider whether the lessee would be reasonably expected to ascribe more value to the non-lease component(s) than to the lease component (see paragraphs 4.4.62 – 4.4.63 and Question 4.4.15). [842-10-15-42B]

4.4.55 All other combined components are accounted for under Topic 842 as a single lease component. This includes when the lease component and non-lease component(s) are equally significant to the contract. If the combined component is accounted for under Topic 842 as a single lease component, the lease is classified as an operating lease by default. A lessor does not assess classification of the single lease component using the guidance in section 7.2. [842-10-15-42B]

4.4.56 A lessor elects this practical expedient by class of underlying asset (see examples in paragraph 4.4.50). [842-10-15-42A]

4.4.57 Effects of electing this practical expedient on transition are discussed in section 13A.5.2 (for the effective date method) and section 13B.5.2 (for the comparative method).

4.4.60 [Not used]

4.4.61 [Not used]



## Observation Predominant element

4.4.62 In many cases, determining whether to account for the combined component as a single lease component or as a single non-lease component in the scope of Topic 606 will be simple. For example, in most real estate lease scenarios it will be clear that the lease is the predominant element of the combined component when it is combined with CAM; this is because, consistent with paragraph 4.4.54, the lessee would clearly be expected to ascribe more value to its right to use the real estate (e.g. the office or retail space) than to the CAM services. Similarly, in many other arrangements, such as those for consumer high-speed internet or cable/satellite television services that include the lease of customer-premise equipment, it will be clear that the services are predominant within the combined component; this is because the consumer would clearly be expected to ascribe more value to its ability to access video content and the internet than to the particular device it uses to obtain that access.

4.4.63 There may be other cases that require more judgment to make this determination because it may not be clear whether the customer would ascribe more value to the lease component or to the non-lease component(s). However, in ‘close call’ situations, given the similarities between the revenue and lessor accounting guidance and the robust disclosure requirements of each, we believe companies and practitioners should be able to reach reasoned conclusions. This is consistent with (1) the public comments of the FASB vice

chairman at the Board's March 28, 2018 meeting, and (2) the Board's statement in the basis for conclusions to ASU 2018-11 that it was "comfortable with allowing stakeholders discretion for determining whether the nonlease component is the *predominant* component." In these close call situations, we believe it may be relevant to give consideration to which Topic's guidance and disclosures will provide more useful information to the entity's financial statement users. [ASU 2018-11.BC35]



#### Question 4.4.05

#### **Non-separation practical expedients – meaning of 'associated with'**

### **How should entities interpret 'associated with' when applying the lessee and lessor non-separation practical expedients?**

**Background:** Paragraphs 4.4.30 and 4.4.51 – 4.4.56 describe practical expedients available to lessees and lessors, respectively, that permit them to not separate non-lease components from lease components to which they relate.

- A lessee may elect (by class of underlying asset) to account for each separate lease component and the non-lease components **associated with** that lease component as a single lease component. [842-10-15-37]
- A lessor may elect (by class of underlying asset) to account for each separate lease component and the non-lease components **associated with** that lease component as a single component if: [842-10-15-42A]
  - the non-lease components otherwise would be accounted for under Topic 606 on revenue from contracts with customers; and
  - two additional criteria are met (see paragraph 4.4.51).

In practice, questions have arisen about whether and how 'associated with' affects an entity's ability to combine a non-lease component with a lease component, including how it applies to contracts that contain:

- multiple separate lease components; and
- non-lease components that specifically relate to the lessee's owned assets (or assets leased from an unrelated third-party lessor).

**Interpretive response:** We believe the 'associated with' language was included principally to ensure that non-lease components are combined with the lease component(s) to which they relate when the contract contains multiple separate lease components.

For example, if a lease contains two leases of equipment, each of which is a separate lease component, and maintenance on both pieces of equipment, the 'associated with' language in the practical expedients means that:

- the maintenance associated with the equipment in lease #1 should be combined with equipment lease component #1; and

- the maintenance associated with the equipment in lease #2 should be combined with equipment lease component #2.

Assigning non-lease components to separate lease components could affect the accounting for the contract. For example, combining the fixed payments for a non-lease component with the wrong lease component could result in incorrect lease classification for either the combined component or another separate lease component. The fixed non-lease payments might incorrectly result in finance lease classification for the combined component, or operating lease classification of the separate lease component with which the non-lease component should have been combined.

#### **Non-lease components related to an asset owned by the lessee or leased from a lessor that is not a party to the contract**

A lease contract might include non-lease services (e.g. maintenance or operations) for equipment the lessee owns or leases from a lessor that is not a party to the contract. For example, a lessor might lease equipment to a lessee and in addition to maintaining that equipment, contract to maintain the lessee's owned equipment.

When a non-lease component specifically relates to one or more assets the lessee owns or leases from a lessor that is not a party to the contract, it should not be combined with a separate lease component of the contract. The same concerns with respect to multiple separate lease components arise in this situation. Combining the non-lease component with (one of) the separate lease component(s) could change the accounting for both – e.g. if it changes the classification of the lease.

The contract might not discuss multiple non-lease components. That is, it might not outline multiple maintenance or operations services, even though the services pertain to both assets leased from the lessor and other owned or leased assets. In that case, the contract's description of the services singularly, rather than as multiple services, should not change the entity's accounting; the entity should allocate the consideration for the single enumerated service between the combined lease component (the lease and the services associated with that leased asset) and a non-lease service component (the service associated with the lessee's owned asset).

#### **Other situations**

So far this response illustrates circumstances in which it is clear that a non-lease component is associated with a particular asset (leased or owned). Those circumstances may frequently exist; for example, it may be clear to which asset(s) maintenance or operations services relate. However, the association may not always be clear. Topic 842 does not provide guidance about whether or how an entity should assess whether a non-lease component is associated with a lease component in those cases. Therefore, judgment will be required.

One approach we believe may be acceptable in making this evaluation (there may be others) is to consider the nature of the relationship between the lease and the non-lease component; this includes how dependent the lessee's ability to use or derive benefit from the non-lease good(s) or service(s) is on the lease.

The following are example considerations that may be relevant in this assessment (not exhaustive).

- A ‘yes’ to the following questions may suggest that the non-lease component is associated with the lease.
    - Must non-lease goods purchased in a lease contract be used with or consumed by the underlying asset?
    - Must services purchased in a lease contract be performed on or using the leased asset?
  - In contrast, a ‘yes’ to the following questions may suggest that the non-lease component is not associated with the lease.
    - Could the lessee use the non-lease goods with a different asset – e.g. use purchased supplies with an owned asset rather than the asset leased from the lessor?
    - Could the lessee direct the lessor to perform the contracted services on an asset other than the asset leased from the lessor – e.g. direct the lessor to perform maintenance on one of the lessee’s owned assets instead of the asset leased from the lessor?
- 



### Example 4.4.05

#### **Non-separation practical expedients – applying 'associated with'**

##### **Scenario 1: Airplane lease and maintenance services**

Lessee LE enters into a five-year airplane lease with Lessor LR. LR is responsible for providing maintenance on the airplane over the lease term.

- The airplane lease would be classified as an operating lease if accounted for separately.
- The maintenance is a stand-ready performance obligation satisfied over time for which a time-elapsed measure of progress toward its complete satisfaction is appropriate – i.e. the maintenance has a straight-line pattern of transfer to the customer.

Both LE and LR have elected their respective non-separation practical expedient for leases of airplanes.

LE and LR both conclude that the maintenance is associated with the airplane lease. Their respective conclusions principally consider that the airplane maintenance provided by LR specifically relates to the airplane being leased from LR and is not transferrable to other airplanes it owns or leases from a different lessor – i.e. LE cannot instruct LR to perform maintenance on its other owned airplanes or airplanes leased from another lessor.

Consequently, the maintenance in this contract is highly dependent on the airplane lease, and LE and LR conclude the maintenance is ‘associated with’ the airplane lease. As a result, LE and LR both account for the airplane lease and the maintenance as a single lease component.

## Scenario 2: Airplane lease and jet fuel

In addition to the airplane lease and the maintenance in Scenario 1, LE commits as part of the contract to purchase a minimum quantity of jet fuel from LR at a fixed price per gallon during the lease term.

There are no restrictions preventing LE from using the jet fuel in LE's other owned and leased (from other lessors) airplanes, or reselling the jet fuel, and LE could obtain equivalent jet fuel from other suppliers.

### **Lessee LE**

LE concludes that the jet fuel is not associated with the airplane lease. This is because the jet fuel it acquires from LR is available for any LE use – e.g. in its other owned or leased aircraft, or for resale to an unrelated third party – and from numerous other suppliers. Therefore, the jet fuel component of this contract is *not* dependent on the airplane lease. Consequently, LE concludes that the lessee non-separation practical expedient cannot be applied to combine the jet fuel component with the airplane lease and maintenance.

### **Lessor LR**

LR cannot combine the jet fuel with the airplane lease and maintenance using the lessor non-separation practical expedient. This is because the jet fuel component is not a performance obligation satisfied over time under Topic 606; therefore, it does not have the same timing and pattern of transfer to LE as the airplane lease (see Question 4.4.13).

Consequently, LR may not consider whether the jet fuel component is 'associated with' the airplane lease in this scenario. However, if LR did, its evaluation would be consistent with LE's.



### Question 4.4.10

#### **Non-separation practical expedients for lessees and lessors not limited to insignificant non-lease components**

### **Do the practical expedients not to separate non-lease components from the lease components to which they relate apply to non-lease components that are significant?**

**Interpretive response:** Yes. Lessees and lessors are permitted to elect their respective practical expedients without regard to whether they expect the non-lease components to which the expedient will apply to be significant to the leases to which they will relate or to their financial statements. [ASU 2016-02.BC150, ASU 2018-11.BC30]

For lessors applying the practical expedient, the accounting for the combined component is determined by the significance of the non-lease component (see paragraphs 4.4.53 – 4.4.55). Lessees do not have a similar requirement and always account for the combined component as a single *lease* component. [ASU 2018-11.BC33]

Once elected for a class of underlying asset, the applicable practical expedient applies to all non-lease components (for lessors, the non-lease components that qualify – see paragraph 4.4.52) that relate to leases within that class of underlying asset regardless of how significant that component is.



### Question 4.4.11

#### **Non-separation practical expedients elected by class of underlying asset**

#### **Can an entity elect the practical expedient not to separate non-lease components from the lease components to which they relate based on the nature of the lease?**

**Background:** Lessees and lessors may enter into leases of similar assets under different terms. For example, lessees/lessors with a significant number of retail or office space leases may enter into gross leases in some cases and net leases in others (paragraph 4.2.120 and Question 4.2.50 explain the distinction between gross leases and net leases). Similarly, leases of similar equipment may be structured with mostly fixed lease payments or mostly variable lease payments.

**Interpretive response:** No. The accounting policy election not to separate non-lease components from the lease components to which they relate is made by *class of underlying asset* (see paragraphs 4.4.50 and 4.4.56). The election cannot be made based on different lease terms and conditions – e.g. whether the lease is a gross lease or a net lease. Different lease terms and conditions do not define a class of underlying asset for the purpose of electing either the lessee or the lessor non-separation practical expedient.



### Question 4.4.12

#### **Lessor practical expedient – operating lease classification criterion**

#### **Is a lessor required to undertake a quantitative analysis to prove that the lease element of a combined component would be classified as an operating lease if accounted for separately?**

**Background:** To combine a lease component with an eligible non-lease component, the lease component must be classified as an operating lease if accounted for separately (see paragraph 4.4.51).

During development of the practical expedient, some stakeholders expressed concern about applying the Part A and Part B ‘present value’ classification tests (see section 7.2). The tests appear to require the lessor to allocate the consideration for the combined component to the lease and non-lease component(s) only to then be able to apply the practical expedient not to

separate and allocate consideration to those same components. This would negate the benefits of the expedient.

**Interpretive response:** No. In response to stakeholder concerns, the Board explained in the basis for conclusions to ASU 2018-11 that it does not intend to require lessors to quantitatively prove the lease passes the present value classification tests by allocating the combined payments to the lease and non-lease components. Rather, similar to the level of evidence needed to apply a portfolio approach (see section 5.8), lessors would meet the practical expedient's operating lease classification criterion if it is reasonably expected, based on an appropriate *qualitative* evaluation, that the lease component would be classified as an operating lease if accounted for separately. [ASU 2016-02.BC120, ASU 2018-11.BC30]

Judgment may be required to determine what constitutes an 'appropriate qualitative evaluation'. The following paragraphs address two acceptable approaches we believe lessors could use to address the practical expedient's operating lease classification criterion. There may be other acceptable approaches.

In many cases, and assuming the lease does not meet any of the other criteria to be classified as a sales-type or direct financing lease, we believe lessors will be able to conclude that the lease would be classified as an operating lease by performing the present value tests using the combined lease and non-lease payments. If the combined payments do not result in sales-type or direct financing classification of the lease under the present value tests, then neither would any other possible allocation of the payments to the lease. For example, this may be the case for some real estate leases where the non-lease CAM component is relatively insignificant in comparison to the lease.

Alternatively, in some cases, a lessor may be able to consider an allocation approach that would not be permissible if allocation to the components was required. For example, even if the lessor is not permitted to use a residual approach to estimate the stand-alone selling price of the lease or non-lease component (see Question 4.4.55), in some cases the results of a residual approach may provide a relevant data point when assessing the practical expedient's operating lease classification criterion. This may be the case if, for example, the residual allocation is to the non-lease component, resulting in a greater allocation to the lease component than would result from using a non-residual allocation technique.



#### Question 4.4.13

#### Lessor practical expedient – same pattern of transfer requirement

### When does a non-lease component meet the same pattern of transfer criterion to qualify for combination with a lease component?

**Background:** Criterion (b) to qualify for the lessor practical expedient (see paragraph 4.4.51) requires that the lease component would be classified as an

operating lease if accounted for separately, which means the pattern of transfer to the lessee of that lease component will generally be straight-line (see section 7.4.2).

**Interpretive response:** In general, to meet the same pattern of transfer requirement, a non-lease component must: [606-10-25-15, 25-27, 25-31 – 25-37, 55-17, 55-20]

- meet one of the Topic 606 criteria to be satisfied over time; and
- have a straight-line pattern of transfer to the lessee – i.e. the Topic 606 measure of progress toward satisfaction of the component must be a time-elapsed input or output measure.

If a lessor concludes that the non-lease component qualifies for recognition over time under Topic 606 but the pattern of transfer to the lessee is something other than time-elapsed, the non-lease component would not qualify for the practical expedient unless the pattern of transfer to the lessee of the operating lease component was also something other than straight-line (which is expected to be extremely rare).

Similarly, if the non-lease component does not meet one of the Topic 606 criteria to be satisfied over time, the practical expedient cannot be applied. At a June 2018 preparer leasing forum, the FASB staff stated that this means arrangements for the sale of goods expected to be used with leased equipment would not qualify for the practical expedient if those goods are determined to be transferred at a point in time, rather than over time, under Topic 606. This is the case even if it is expected that goods will be sold for use with the leased equipment throughout the lease term.



#### Question 4.4.14

#### **Lessor practical expedient – measure of progress toward satisfaction of a combined Topic 606 component**

**Is a lessor permitted to use a measure of progress in recognizing revenue for a combined component accounted for under Topic 606 different from that applied to the lease and non-lease elements of the combined component when evaluating the criterion in paragraph 842-10-15-42A(a)?**

**Background:** To apply the lessor non-separation practical expedient to a lease and a non-lease component, those two components must have the same timing and pattern of transfer to the lessee (see paragraph 4.4.51). As outlined in Question 4.4.13, the pattern of transfer of both components will generally be straight-line.

Consider an example of a lessor providing an operating lease and operations and maintenance services. The lessor concludes that the lease component and the non-lease operations and maintenance services can be combined because each component would have a straight-line pattern of transfer to the lessee – i.e. each component is satisfied over time and the lessor would use a time-elapsed measure of progress toward complete satisfaction of each component.

If the combined component is accounted for under Topic 606 – i.e. because the non-lease element(s) of the combined component is (are) predominant, a question arises about whether it is acceptable to measure progress toward complete satisfaction of the combined component on a basis other than time elapsed (e.g. on a cost-to-cost input basis).

**Interpretive response:** No. Paragraph 842-10-15-42B(a)(1) explicitly states that a lessor must use the same measure of progress for the combined Topic 606 performance obligation as it used when evaluating the criterion in paragraph 842-10-15-42A(a).

This means that the measure of progress for a combined Topic 606 performance obligation will generally be (and in the background example *must* be) time-elapsed (see Question 4.4.13).



### Question 4.4.15 Lessor practical expedient – evaluating predominance

#### Is a lessor required to evaluate predominance of the lease component or non-lease component(s) quantitatively?

**Interpretive response:** No. The basis for conclusions to ASU 2018-11 states explicitly that, “The Board concluded that an entity should be able to reasonably determine which Topic to apply (based on predominance) without having to perform a detailed quantitative analysis or theoretical allocation to each component.” Therefore, we believe it would be inconsistent with the Board’s view to require a quantitative predominance evaluation. [ASU 2018-11.BC35]

Further, when considering predominance, the lessor considers whether the lessee would be reasonably expected to ascribe more value to the non-lease component(s) than to the lease component (see paragraph 4.4.53). [842-10-15-42B]

We believe this assessment is inherently a qualitative, rather than quantitative, evaluation that would necessarily consider generally qualitative information about how the lessor markets and promotes itself to customers. Particularly relevant, given that each combined component is subject to its own predominance evaluation, will likely be how the lessor promoted itself and the relevant lease and non-lease components in the context of the present contract – e.g. its response to the relevant customer request for proposal.

Notwithstanding the above, there may be available and relevant quantitative information other than a theoretical allocation to the components that should be considered as part of the analysis. One example could be quantitative information about the lessor’s costs to fulfill the components. Assuming the lessor expects that the customer has at least some understanding of the lessor’s relative efforts and costs to fulfill the components, that cost information may be relevant when evaluating the relative value a customer would be expected to ascribe to the lease and non-lease component(s).



### Question 4.4.16

#### **Lessor practical expedient – lease and services are not coterminous**

#### **Can the lessor apply the non-separation practical expedient when the lease and non-lease components are not coterminous?**

**Background:** Consider a scenario in which Lessor LR and Lessee LE enter into a three-year lease of equipment that includes one year of bundled maintenance. LE has the option to renew the maintenance for each of the two remaining years of the equipment lease. If LE does renew the maintenance services for Year 2 or Year 3, its total payment to LR for that year will be the same as in Year 1. The equipment lease is an operating lease, and the maintenance is a stand-ready performance obligation for which a time-elapsed measure of progress is appropriate under Topic 606.

In this scenario, the question arises as to whether LR is permitted to apply the lessor non-separation practical expedient when the promised maintenance services are only for part of the equipment lease term.

**Interpretive response:** No. For the lessor non-separation practical expedient to apply, we believe the lease and the non-lease component must be satisfied over the same period of time – i.e. the lease term and the term of the non-lease component must be coterminous.

Our view is based on the following.

- The basis for conclusions to ASU 2018-11 indicates the FASB intended that the lease and the non-lease component must be coterminous for the lessor non-separation practical expedient to apply. Paragraph BC27(b), in explaining the criterion in paragraph 4.4.51(a), states that having the same timing and pattern of transfer means that the lease and the non-lease component each have a straight-line pattern of transfer to the customer ‘over the same time period’. [\[ASU 2018-11.BC27\(b\)\]](#)
- The practical expedient was developed with the intent that it be applied in the same manner as the similar practical expedient in Topic 606. Under Topic 606, entities are permitted to account for two or more distinct goods or services that are *concurrently delivered* and have the same pattern of transfer to the customer as a single performance obligation. Two services, transferred over three years and one year, respectively, would not be eligible to be accounted for as a single performance obligation because they are not ‘concurrently delivered’. To be consistent, the lessor non-separation practical expedient would similarly not apply to an operating lease and a service provided over different periods of time. [\[ASU 2014-09.BC116, ASU 2018-11.BC21\]](#)
- The basis for conclusions to ASU 2018-11 and the public Board discussions of the practical expedient both indicate that the principal application issue influencing creation of the practical expedient was the difficulty cited by many lessors in determining stand-alone selling prices for lease and non-lease components that are rarely, if ever, sold separately (e.g. lease and

maintenance and/or operations services always sold together coterminously).

Consequently, we do not believe the FASB intended for the practical expedient to apply to contracts where this application issue generally should not exist. Determining stand-alone selling prices, and allocating the consideration in the contract accordingly, should be less difficult and require less estimation in contracts like the background example, because the lessor's stand-alone sales of the services (through renewals, separate from the longer term lease component), will generally provide observable stand-alone pricing information about the services that does not exist if the lease and services are always sold together as a bundle. [ASU 2018-11.BC19, BC22]

We believe an exception arises if the lessee has the option to renew a shorter term non-lease component for the full duration of the 'lease term' or longer, and: [606-10-55-42 – 55-43, 55-45]

- the option provides the lessee with a material right;
  - the lessor has elected and is permitted to apply the practical expedient in paragraph 606-10-55-45 to account for the material right; and
  - the lessor expects, in accordance with paragraph 606-10-55-45, to provide the non-lease service for a period equal to (neither shorter than, nor exceeding) the lease term.
- 

### ***Lessee allocation of the consideration in the contract***

4.4.70 The consideration in the contract is allocated to the separate lease and non-lease components on a relative stand-alone price basis. The stand-alone price of a component is the price at which a customer would purchase that component separately. Lessees are required to use observable stand-alone prices when they are available and to estimate stand-alone prices if observable prices are not available. [842-10-15-33, 842 Glossary]

4.4.80 Initial direct costs are allocated to the separate lease components on the same basis as the lease payments. The definition of and accounting for initial direct costs are discussed in section 5.5.

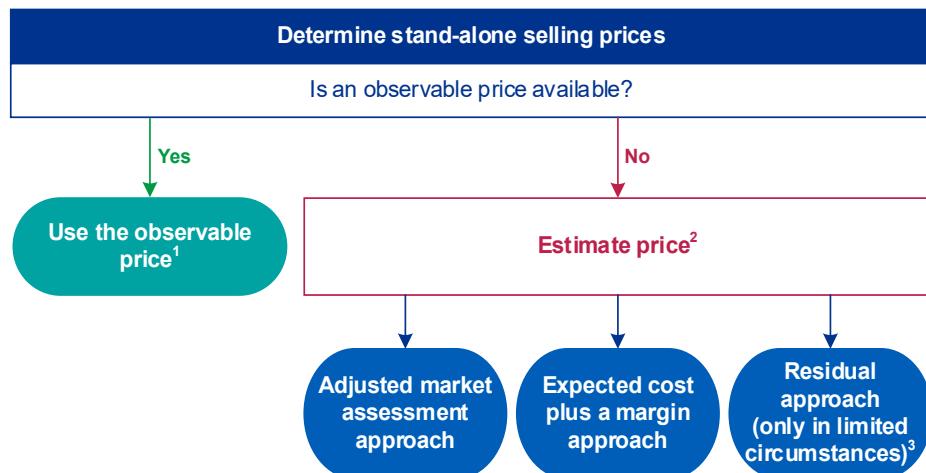
4.4.90 An observable stand-alone price is the price charged by the lessor or similar suppliers for a similar lease or non-lease component – i.e. a lease of a substantially similar asset or non-lease component under similar terms and conditions; for example, with respect to duration and payment terms – on a stand-alone basis. When estimating stand-alone prices, lessees are required to maximize the use of observable information. In some circumstances, using a residual approach for estimating the stand-alone price of a separate lease or non-lease component may be appropriate (see Question 4.4.56 and Example 4.4.20). For example, a residual estimation approach may be appropriate if the stand-alone price for a component is highly variable or uncertain. [842-10-15-33 – 15-34]

### ***Lessor allocation of the consideration in the contract***

4.4.100 In following the guidance in Topic 606, a lessor allocates the consideration in the contract to each separate lease and non-lease component to depict the amount of consideration to which the lessor expects to be entitled

(i.e. consistent with the 'allocation objective in Topic 606 – see chapter 6 of KPMG Handbook, [Revenue recognition](#)). [842-10-15-38, 606-10-32-28]

4.4.110 The lessor will generally allocate the consideration in the contract to each separate lease component and each non-lease component on a relative basis in proportion to its stand-alone selling price, which is determined as follows. [606-10-32-29 – 32-35]



Notes:

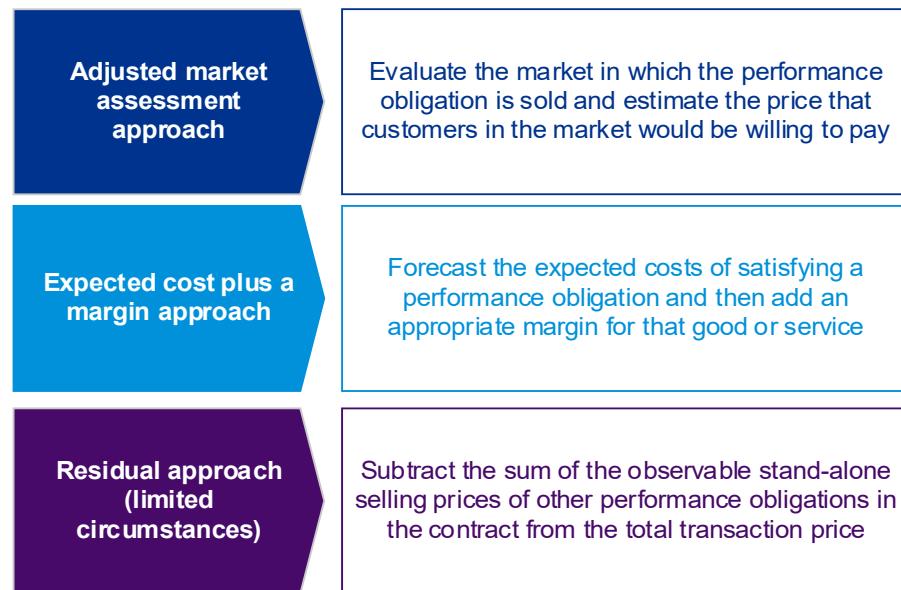
1. An observable price is the price at which the lessor sells that component separately in similar circumstances and to similar customers.
2. A lessor considers all information that is reasonably available when estimating a stand-alone selling price – e.g. market conditions, entity-specific factors, and information about the lessee. A lessor also maximizes the use of observable inputs and applies consistent methods to estimate the stand-alone selling price of components with similar characteristics.
3. See Question 4.4.55.

4.4.120 Consistent with other components of 'lease payments', lease incentives may be an allocated number. That is, a lessor may grant incentives to a lessee in a contract that includes lease and non-lease components. All incentives, however characterized (i.e. as a lease incentive or otherwise), reduce the consideration in the contract (see section 4.3), which is allocated to the components of the contract either on a relative stand-alone price basis (lessees) or in accordance with the transaction price allocation guidance in Topic 606 (lessors). Consequently, a portion of amounts characterized as lease incentives may not be accounted for as such (i.e. may be allocated to a non-lease component) and vice versa.

4.4.130 In some circumstances, the transaction price allocation guidance in Topic 606 requires the lessor to allocate a bundled discount or variable consideration on an other-than-relative basis to the components of the contract – i.e. a bundled discount or variable consideration may be allocated entirely to only one or some, but not all, of the components (see chapter 6 of KPMG Handbook, [Revenue recognition](#)). [606-10-32-36 – 32-41]

4.4.140 Topic 606 does not preclude or prescribe any particular method for estimating the stand-alone selling price of a good or service when observable

stand-alone selling prices are not available but describes the following estimation methods as suitable approaches. [606-10-32-34]



### Question 4.4.17\*\* **Changes to the election of a practical expedient**

**Is an election to no longer apply a practical expedient, or to elect a practical expedient not previously applied, a change in accounting principle?**

**Interpretive response:** Yes. When US GAAP permits the election of a practical expedient, the practical expedient and the regular approach are both considered acceptable accounting principles. If an entity wants to elect to no longer apply a practical expedient in Topic 842, or to adopt a practical expedient that it previously elected not to apply, that would be a voluntary change in accounting principle under Topic 250, requiring a preferability assessment. Whether the change can be justified as preferable depends on an entity's individual facts and circumstances. See section 3.3 of KPMG Handbook, [Accounting changes and error corrections](#), for guidance on assessing, accounting for and disclosing changes in accounting principle. [250-10-45-2]



### Question 4.4.30

#### **Allocation on a relative stand-alone price basis**

### **How is the guidance for allocating consideration different for lessees and lessors?**

**Interpretive response:** Lessees always allocate the consideration in the contract on a relative stand-alone price basis. In contrast, because lessors apply the transaction price allocation guidance in Topic 606, in some cases they will allocate a discount or variable consideration that is accounted for as consideration in the contract to only one or some of the separate lease or non-lease components of the contract. [842-10-15-33, 15-38]



### Question 4.4.40

#### **Different perspectives on observable stand-alone (selling) prices**

### **How is an observable stand-alone price for a lessee different from an observable stand-alone selling price for a lessor?**

**Interpretive response:** For the **lessee**, observable stand-alone prices include those charged not only by the lessor but also by other suppliers for the same or a similar component – e.g. the price charged for the lease of a similar piece of equipment or for similar services. [842-10-15-34]

For the **lessor**, the definition of observable stand-alone selling price is more restrictive, both in terms of using similar goods or services and considering suppliers other than the lessor. Taken from Topic 606, an observable stand-alone selling price is the price for which the *entity* sells *that* good or service separately in similar circumstances and to similar customers. [606-10-32-32]

However, applying a market assessment approach under Topic 606 might include referring to prices from the lessor's competitors for similar goods or services (and adjusting those prices as necessary to reflect the lessor's costs and margins) as an acceptable technique for estimating the stand-alone selling price. Therefore, while the lessor might use similar information to the lessee, its stand-alone selling price of a component may be considered 'estimated', while the lessee's stand-alone price may be considered 'observable'. [606-10-32-34]



### Observation

#### **Burden of proof for observable stand-alone (selling) prices**

4.4.150 Both lessees and lessors are required to maximize the use of observable information in determining the stand-alone (selling) price of contract components. However, we believe the Board generally intended to permit

lessees to estimate stand-alone prices more frequently than lessors. This is evidenced by the fact that Topic 842 requires a lessee to estimate stand-alone prices when observable stand-alone prices are not 'readily available'. We believe it was the Board's intent that lessees should not have to exhaustively search for observable stand-alone prices, particularly when such a requirement might put significant pressure on lessors to provide proprietary information to lessees.



### Example 4.4.10

#### **Allocating the consideration in the contract – observable inputs**

*This example assumes that Lessee LE and Lessor LR have not elected the non-separation practical expedients in paragraphs 4.4.30 – 4.4.50 and paragraphs 4.4.51 – 4.4.56, respectively.*

Lessor LR leases a bulldozer to Lessee LE to be used in LE's mining operations. LR also provides maintenance services for the bulldozer for the entire lease term. Total consideration for the use of the bulldozer and the maintenance services over the term of the contract is \$125,000. There is no variable consideration.

LR and LE each consider stand-alone (selling) prices.

- LR regularly leases bulldozers separately for comparable lease terms under similar terms and conditions. Therefore, both LE and LR have access to observable stand-alone (selling) prices for the lease component (\$100,000).
- Although LR does not provide maintenance services separately from its equipment leases, there are many other service providers that do under similar terms and conditions (e.g. for similar periods and with similar payment terms). Both LR and LE arrive at a stand-alone (selling) price of \$40,000, but their approaches differ.
  - LE is able to obtain an observable stand-alone price for the maintenance services. The price of service providers other than LR for similar services constitutes an observable stand-alone price for LE.
  - The price charged by other service providers does not constitute an observable stand-alone selling price for LR; instead, LR uses the rates charged by other service providers to estimate a stand-alone selling price for the maintenance services (i.e. using a market assessment approach).

In this example, the allocation of consideration is the same for both LR and LE.

Component	Stand-alone price	Allocation	Calculation
Bulldozer lease	\$100,000	\$ 89,286	$(100,000 / 140,000) \times 125,000$
Maintenance	40,000	35,714	$(40,000 / 140,000) \times 125,000$
	<b>\$140,000</b>	<b>\$125,000</b>	



## Question 4.4.50

### Different estimation techniques

#### How might the techniques used to estimate stand-alone (selling) prices differ for lessees and lessors?

**Interpretive response:** Lessees may rely on estimation techniques different from those used by lessors because lessors will frequently have greater access to observable information – e.g. their own incurred cost data or nonpublic industry information on the pricing of lease or related non-lease components. Even so, it will generally not be appropriate for a lessee to default to the residual approach when another approach would give a more representative result. Estimation techniques used should be reasonable, applied consistently to similar circumstances, and not developed with a bias to reducing amounts allocated to lease components. [ASU 2016-02.BC156]



## Question 4.4.55

### Stand-alone selling price estimation methods – residual approach (lessors)

#### When can a lessor use the residual approach to estimate stand-alone selling price?

**Interpretive response:** The residual approach is appropriate only if the stand-alone selling price of one or more goods or services is highly variable or uncertain, and observable stand-alone selling prices exist for the other goods or services promised in the contract. [606-10-32-34(c)]

Selling price is ...	If ...
<b>Highly variable</b>	The entity sells the same good or service to different customers at or near the same time for a broad range of prices.
<b>Uncertain</b>	The entity has not yet established the price for a good or service and the good or service has not previously been sold on a stand-alone basis.

If two or more goods or services in a lease have highly variable or uncertain stand-alone selling prices, a lessor may need to use a combination of methods to estimate the stand-alone selling prices of the lease and non-lease components in the contract. For example, a lessor may use:

- the residual approach to estimate the aggregate stand-alone selling prices for all of the promised goods or services with highly variable or uncertain stand-alone selling prices; and then

- another technique to estimate the stand-alone selling prices of the individual goods or services in the bundle that was determined by the residual approach. [606-10-32-35]

Additionally, the residual approach is not appropriate if it results in zero or very little consideration being allocated to a component, or to a bundle of components. [606-10-55-269, ASU 2014-09.BC273]

Another approach may be more appropriate to estimate the stand-alone selling price of a lease or non-lease component even if the criteria to use the residual approach are met. Topic 842 uses the transaction price allocation guidance in Topic 606 to allocate the consideration in the contract to lease and non-lease components of the contract. Topic 606 requires that the method used to estimate a stand-alone selling price maximize the use of observable inputs. When there are observable inputs such as third-party pricing, or cost and/or margin data from selling the same or similar goods or services another approach may be more appropriate. [606-10-32-33]

Additional guidance is provided on estimating stand-alone selling prices in chapter 6 of KPMG Handbook, [Revenue recognition](#).

## Question 4.4.56



### **Stand-alone selling price estimation methods – residual approach (lessees)**

#### **When can a lessee use the residual approach to estimate stand-alone selling price?**

**Interpretive response:** We believe four criteria need to be met for a lessee to use the residual approach to estimate the stand-alone price of a component of a contract. These criteria are broadly consistent with those for lessors (see Question 4.4.55), which is because the allocation guidance for lessees was intended to be similar to, and was largely drawn from, the Topic 606 transaction price allocation guidance lessors are required to apply. [ASU 2016-02.BC156]

Criteria 1 and 2 are included in Topic 842, while Criteria 3 and 4 are drawn from the Board's statement that the lessee allocation guidance is intended to be similar to that for lessors (without directing lessees to the revenue recognition guidance).

#### **Criterion 1: Highly variable or uncertain stand-alone price**

Using the residual approach to estimate the stand-alone price of a component is appropriate only if the stand-alone price of the component to which the approach would be applied is highly variable or uncertain. [842-10-15-33(a), ASU 2016-02.BC155(a)]

Stand-alone price is ...	If ...
<b>Highly variable</b>	The price at which the lessee could purchase the same or a substantially similar good or service in the same timeframe is widely varied.

Stand-alone price is ...	If ...
<b>Uncertain</b>	The same or a substantially similar good or service is not, and has not previously been, sold on a stand-alone basis such that its stand-alone price has not been established.

### Criterion 2: Other observable data is considered first

Topic 842 requires that the method used to estimate a stand-alone price maximize the use of observable inputs (or information). Therefore, before using a residual estimation approach, the lessee must consider whether another estimation approach that maximizes the use of observable information/inputs, such as observable cost and/or margin information, is more appropriate. [842-10-15-33(a), ASU 2016-02.BC155(a)]

### Criterion 3: Residual approach does not produce zero or de minimis stand-alone price

Consistent with the requirements for lessors, we believe a residual estimation approach is not appropriate if it results in zero or very little consideration being allocated to a component, or to a bundle of components. It is inconsistent with the view that the component transfers a good or service – i.e. provides benefit to the lessee – to conclude that it has no stand-alone value. [606-10-55-269, ASU 2014-09.BC273]

### Criterion 4: Observable stand-alone prices for other components

To apply the residual approach, the lessee needs to have observable stand-alone prices (see paragraph 4.4.90) for the components of the contract for which the residual approach will not be used to estimate their stand-alone prices. This is consistent with the requirement for lessors that observable stand-alone selling prices exist for the other components of the contract; however, as outlined in Question 4.4.40, what constitutes an ‘observable stand-alone price’ for a lessee is not the same as what constitutes an ‘observable stand-alone selling price’ for a lessor.

### Residual bundles

Consistent with the allocation guidance for lessors (see Question 4.4.55), if two or more goods or services in a lease have highly variable or uncertain stand-alone selling prices, a lessee may need to use a combination of methods to estimate the stand-alone prices of the lease and non-lease components in the contract. For example, the lessee may use:

- the residual approach to estimate the aggregate stand-alone prices for all of the components with highly variable or uncertain stand-alone prices; and then
- another technique to estimate the stand-alone prices of the components in the residual bundle.



### Example 4.4.20

#### **Allocating the consideration in the contract – observable and estimated stand-alone (selling) prices (1)**

*This example assumes that Lessee LE and Lessor LR have not elected the non-separation practical expedients in paragraphs 4.4.30 – 4.4.50 and paragraphs 4.4.51 – 4.4.56, respectively.*

Lessor LR leases a specialized machine for two years to Lessee LE, and provides consulting services to help LE effectively use the machine in its production processes. The machine is not sold or leased separately by LR and there are no similar machines for sale or lease from other suppliers.

The contract consideration is \$100,000 for the first year and \$80,000 for the second year. LR priced the contract in this way assuming that it will provide more consulting services in the first year.

#### **Lessee**

Because LR does not sell or lease the specialized machine, or provide substantially equivalent consulting services separately, LE allocates the consideration in the contract based on observable and estimated relative stand-alone prices.

LE determines the stand-alone prices for the lease and the consulting services as follows.

- LE obtains an observable stand-alone price for the consulting services based on similar services offered in the marketplace (\$40,000).
- There are no similar machines for sale or lease from suppliers other than LR, and therefore LE cannot obtain an observable stand-alone price or use a market-based assessment estimation approach. In addition, LE also does not have the information needed to apply an expected cost-plus-margin approach. Consequently, because LE has an observable stand-alone price for the consulting services and using a residual approach would not result in an estimated stand-alone price that is \$0 or de minimis, LE concludes that a residual approach is reasonable and appropriate in the circumstances.

On this basis, LE allocates the consideration as follows.

Component	Stand-alone price	Allocation	Calculation <sup>1</sup>
Machine lease	\$140,000	\$140,000	Residual (180,000 – 40,000)
Consulting	40,000	40,000	Observable price
	<b>\$180,000</b>	<b>\$180,000</b>	

Note:

1. This calculation relates to determining the stand-alone prices, which are then allocated to the components of the contract.

#### **Lessor**

Because LR does not sell or lease the specialized machine, or provide substantially equivalent consulting services separately, LR allocates the consideration in the contract on a relative basis using estimated stand-alone selling prices.

LR estimates the stand-alone selling prices as follows.

- The specialized nature of the machine precludes using a market assessment approach – i.e. there are no similar machines for lease by other suppliers to assess. Consequently, LR uses another estimation technique to arrive at a stand-alone selling price of \$160,000 for the machine lease.
- LR uses a market-based assessment approach to arrive at a stand-alone selling price of \$40,000 for the consulting services based on similar services offered in the consulting marketplace.

On this basis, LR allocates the consideration as follows.

Component	Stand-alone price	Allocation	Calculation
Machine lease	\$160,000	\$144,000	$(160,000 / 200,000) \times 180,000$
Consulting	40,000	36,000	$(40,000 / 200,000) \times 180,000$
	<b>\$200,000</b>	<b>\$180,000</b>	



### Example 4.4.25

#### Embedded supply agreement lease with minimum purchase quantities – lessee accounting

*This example assumes that Lessee LE has not elected the non-separation practical expedient in paragraphs 4.4.30 – 4.4.50.*

##### Scenario 1: Annual purchase minimum

Lessee LE enters into a five-year supply contract for widgets from Manufacturer LR. On the basis that LE will have exclusive rights to the output from LR's facility that produces the widgets over the five-year contract term, and LR's production from the facility will be dictated by LE's purchase orders, LE concludes it is leasing LR's facility. The lease is classified as an operating lease because none of the criteria in paragraph 842-10-25-2 are met.

LR will operate the production facility throughout the contract term – i.e. operating and maintaining the facility and its component equipment. Its service (O&M) to do so is a non-lease component of the contract.

The following additional facts are relevant.

Contract payments:	\$1.50 per widget, subject to an annual minimum of 1,000 widgets
Non-cancellable contract term:	5 years
Renewal or termination options:	None
LE's incremental borrowing rate (implicit rate is not readily determinable):	6%
IDCs, lease incentives or lease prepayments:	None

Based on its forecasts and experience, LE expects to purchase between 1,800 and 2,400 widgets per year over the five-year term of the supply contract. This equates to LE payments to LR of between \$13,500 and \$18,000 over that period.

However, because LE is only required to purchase 1,000 widgets per year, the consideration in the contract at lease commencement is only \$7,500 (1,000 widgets  $\times$  \$1.50  $\times$  5 years). Any payments for widgets above the minimum are variable payments not part of the consideration in the contract.

LE considers the stand-alone prices of the facility lease and the O&M services. LR does not lease production facilities or provide operations services for other entities' facilities. In addition, there are not observable stand-alone prices from other suppliers for either similar leases or similar O&M services.

Therefore, LE estimates the stand-alone prices of each, and allocates the consideration in the contract as follows.

Component	Stand-alone price	Allocation	Calculation	Allocation per widget	Calculation
Facility lease	\$ 6,000	\$ 4,500	$(6,000 / 10,000) \times 7,500$	\$ 0.90	$(6,000 / 10,000) \times \$1.50$
O&M services	4,000	3,000	$(4,000 / 10,000) \times 7,500$	0.60	$(4,000 / 10,000) \times \$1.50$
	<b>\$10,000</b>	<b>\$7,500</b>			

Consistent with paragraphs 4.4.220 and 4.4.221, LE recognizes the variable payments for widgets above the contract minimums when incurred as a result of LR production. It allocates those payments to the facility lease and operations services consistent with the allocation in the table – i.e. \$0.90 per widget to the facility lease and \$0.60 per widget to the O&M services.

Assuming the actual widget purchases in the following table and no lease remeasurements, contract modifications or ROU asset impairments, LE accounts for the lease liability, ROU asset and lease cost as follows over the five-year lease term. For ease of illustration, it is assumed that payments for the purchased widgets are made at the end of each year in arrears.

Yr.	Widgets purch. <sup>1</sup>	Lease liab. / ROU asset <sup>2</sup>	Lease liab. accr <sup>3</sup>	ROU asset amort. <sup>4</sup>	Single lease cost <sup>5</sup>	Variable lease cost <sup>6</sup>	Total lease cost <sup>7</sup>	Ops cost <sup>8</sup>
		\$ 3,791	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
1	1,900	3,119	227	673	900	810	1,710	1,140
2	2,000	2,406	187	713	900	900	1,800	1,200
3	2,100	1,650	144	756	900	990	1,890	1,260
4	2,200	849	99	801	900	1,080	1,980	1,320
5	2,400	0	51	849	900	1,260	2,160	1,440

## Notes:

1. Actual widgets purchased by LE.
2. The lease liability and the ROU asset are equal at the end of each year of the lease term because there are no lease prepayments, IDCs or lease incentives.
3. Lease liability accretion = prior year lease liability balance  $\times$  6%.
4. ROU asset amortization = single lease cost – lease liability accretion.
5. The single lease cost equals \$4,500, which is the ‘lease payments’ allocated to the lease component (5,000 widgets  $\times$  \$0.90). Amount calculated as (\$4,500 / 5 years = \$900 per year).
6. Variable lease cost = (total widgets purchased for the year  $\times$  \$0.90) – single lease cost for the year.
7. Total lease cost = single lease cost + variable lease cost. LE capitalizes lease cost as part of the carrying amount of its widget inventory; see paragraph 6.4.70.
8. O&M service (i.e. non-lease component) cost = total widgets purchased for the year  $\times$  \$0.60 per widget.

**Scenario 2: Cumulative purchase minimum (1)**

Assume the same facts as Scenario 1, except that instead of an *annual* purchase minimum of 1,000 widgets per year, the contract stipulates a *cumulative* minimum for the five-year contract term of 6,000 widgets.

LE recognizes the single lease cost of \$5,400 (6,000 widgets  $\times$  \$0.90 per widget for the lease component) on a straight-line basis over the five-year lease term; the ROU asset is also amortized over that same period.

In contrast, the lease liability is reduced as widgets are produced and paid for by LE such that the lease liability is reduced to \$0 once the cumulative minimum purchase requirement has been met. Based on actual purchases in the table below, the lease liability is \$0 at the end of Year 3.

Consistent with paragraph 4.3.20, LE does not include the variable payments from widget purchases above the cumulative minimum volume in the consideration in the contract. Those variable payments do not depend on an index or rate and are not in-substance fixed.

Assuming the actual widget purchases in the following table and no lease remeasurements, contract modifications or ROU asset impairments, LE accounts for the lease liability, ROU asset and lease cost as follows over the five-year lease term. For ease of illustration, it is assumed that payments for the purchased widgets are made at the end of each year in arrears.

Yr.	Lease liability				ROU asset		
	Beg. balance	Liability accret. <sup>1</sup>	Lease pmts. <sup>2</sup>	End. balance	Beg. balance	Amort. <sup>3</sup>	End. Balance
1	\$ 4,802	\$ 288	\$ (1,710)	\$ 3,380	\$ 4,802	\$ (792)	\$ 4,010
2	3,380	203	(1,800)	1,783	4,010	(877)	3,133
3	1,783	107	(1,890)	0	3,133	(973)	2,160
4	0	0	(1,980)	0	2,160	(1,080)	1,080
5	0	0	(2,160)	0	1,080	(1,080)	0

## Notes:

1. Lease liability accretion = beginning lease liability balance  $\times$  6%.
2. Lease payments = widgets purchased  $\times$  \$0.90 per widget.
3. ROU asset amortization = single lease cost below – lease liability accretion.

Yr.	Widgets purchased <sup>4</sup>	Single lease cost <sup>5</sup>	Variable lease cost <sup>6</sup>	Total lease cost <sup>7</sup>	O&M svc. cost <sup>8</sup>
1	1,900	\$ 1,080	\$ 630	\$ 1,710	\$ 1,140
2	2,000	1,080	720	1,800	1,200
3	2,100	1,080	810	1,890	1,260
4	2,200	1,080	900	1,980	1,320
5	2,400	1,080	1,080	2,160	1,440

## Notes:

1. Actual widgets purchased by LE.
2. The single lease cost equals \$5,400, which is the 'lease payments' allocated to the lease component (6,000 widgets  $\times$  \$0.90). Annual amount calculated as (\$5,400 / 5 years = \$1,080 per year).
3. Variable lease cost = (total widgets purchased for the year  $\times$  \$0.90) – single lease cost for the year.
4. Total lease cost = single lease cost + variable lease cost. LE capitalizes lease cost as part of the carrying amount of its widget inventory; see paragraph 6.4.70.
5. O&M service (i.e. non-lease component) cost = total widgets purchased for the year  $\times$  \$0.60 per widget.

**Scenario 3: Cumulative purchase minimum (2)**

Assume the same facts as Scenario 2.

In contrast to Scenario 2, LE recognizes the single lease cost of \$5,400 (6,000 widgets  $\times$  \$0.90 per widget for lease component) on a straight-line basis over the anticipated period it will take LE to reach the cumulative purchase minimum of 6,000 widgets. In this scenario, that is three years.

The ROU asset is amortized over that same three-year period.

The following are consistent with Scenario 2.

- The lease liability is reduced as widgets are produced and paid for by LE such that the lease liability is reduced to \$0 once the cumulative minimum purchase requirement has been met. Based on actual purchases in the table below, the lease liability is \$0 at the end of Year 3.
- LE does not include the variable payments from widget purchases above the cumulative minimum volume in the consideration in the contract. Those variable payments do not depend on an index or rate and are not in-substance fixed.

Assuming the actual widget purchases in the following table and no lease remeasurements, contract modifications or ROU asset impairments, LE accounts for the lease liability, ROU asset and lease cost as follows over the

five-year lease term. For ease of illustration, it is assumed that payments for the purchased widgets are made at the end of each year in arrears.

Yr.	Lease liability				ROU asset		
	Beg. balance	Liability accret. <sup>1</sup>	Lease pmts. <sup>2</sup>	End. balance	Beg. balance	Amort. <sup>3</sup>	End. Balance
1	\$4,802	\$288	(\$1,710)	\$3,380	\$4,802	(\$1,512)	\$3,290
2	3,380	203	(1,800)	1,783	3,290	(1,597)	1,693
3	1,783	107	(1,890)	0	1,693	(1,693)	0
4	0	0	(1,980)	0	0	(0)	0
5	0	0	(2,160)	0	0	(0)	0

Notes:

1. Lease liability accretion = beginning lease liability balance  $\times$  6%.
2. Lease payments = widgets purchased  $\times$  \$0.90 per widget.
3. ROU asset amortization = single lease cost below – lease liability accretion.

Yr.	Widgets purchased <sup>4</sup>	Single lease cost <sup>5</sup>	Variable lease cost <sup>6</sup>	Total lease cost <sup>8</sup>	O&M svc. Cost <sup>9</sup>
1	1,900	\$ 1,800	\$ 0 <sup>6</sup>	\$ 1,800	\$ 1,800
2	2,000	1,800	0 <sup>6</sup>	1,800	1,800
3	2,100	1,800	0 <sup>7</sup>	1,800	1,800
4	2,200	0	1,980 <sup>6</sup>	1,980	1,980
5	2,400	0	2,160 <sup>6</sup>	2,160	2,160

Notes:

4. Actual widgets purchased by LE.
5. The single lease cost equals \$5,400, which is the 'lease payments' allocated to the lease component (6,000 widgets  $\times$  \$0.90). Annual amount calculated as (\$5,400 / 3 years = \$1,800 per year).
6. Variable lease cost = (total widgets purchased for the year  $\times$  \$0.90) – single lease cost for the year.
7. Year 3 single lease cost reflects the reversal of the \$90 in deferred rent created in year 1, when LE's purchase of only 1,900 widgets incurred payments to LR of only \$1,710. It is for this reason that there is no variable lease cost in year 3 despite that LE's purchases of 2,100 widgets incurred payments to LR of \$1,890.
8. Total lease cost = single lease cost + variable lease cost. LE capitalizes lease cost as part of the carrying amount of its widget inventory – see paragraph 6.4.70.
9. O&M service (i.e. non-lease component) cost = total widgets purchased for the year  $\times$  \$0.60 per widget.



### Question 4.4.60

#### **Allocating consideration when there are multiple lease and multiple non-lease components**

**How does the method for allocating consideration when there are multiple lease and multiple non-lease components differ for lessors and lessees?**

**Interpretive response:** For lessors, we believe each separate lease and non-lease component needs to be identified *before* allocating the consideration in the contract, which is the methodology followed in the examples in Topic 842. Non-lease components are assessed for separation from each other using the guidance on identifying performance obligations in Topic 606.

This means that each separate component – whether lease or non-lease – is a separate unit of account for the purpose of determining stand-alone selling prices and allocating consideration. This is relevant because a bundle of two or more components may have a different stand-alone selling price (e.g. a bundled discount) that would affect allocation if components were grouped. [842-10-55-132 – 55-137, ASU 2016-02.BC145]

We believe the Board intended for lessees to identify the separate lease components of the contract and then account for non-lease components that relate to *different* separate lease components as separate units of account.

It is not clear whether a lessee would be required to separately account for multiple non-lease components that relate to a single lease component. In such cases, it may be acceptable for a lessee to determine the stand-alone price for multiple non-lease components that relate to a single lease component as a bundle. However, because Topic 842 requires that stand-alone prices be observable (when readily available) and the use of observable data maximized when stand-alone prices are estimated, that might limit lessees' choices in this regard. For example, the requirement to maximize the use of observable data generally means that it is not appropriate to estimate the stand-alone price of a bundle that is not regularly sold separately if there are readily available observable prices for the non-lease components individually.



### Question 4.4.65

#### **Allocating consideration in related party leases**

**Should an entity allocate consideration in the contract for a related party lease based on stand-alone (selling) prices?**

**Background:** An entity classifies a lease on the basis of its legally enforceable terms and conditions if the lease is between: [842-10-55-12]

- related parties not under common control; or
- parties under common control to which the practical expedient described below is not applied.

See paragraph 6.2.210 regarding related party leases.

These leases are also recognized and measured based on the legally enforceable terms and conditions of the arrangement. As stated in the basis for conclusions to ASU 2016-02, the accounting that results therefrom is not adjusted to reflect the economic substance of the arrangement. [\[ASU 2016-02.BC374\]](#)

For common control leases, an entity can elect, on an arrangement-by-arrangement basis, a practical expedient to classify and account for the lease based solely on the written terms and conditions, regardless of whether those terms and conditions are legally enforceable (see section 3.1.2). [\[842-10-15-3A\]](#)

**Interpretive response:** It depends on whether the related party lease is between entities under common control and, if so, whether the entity elected the written terms and conditions practical expedient.

#### **Lease is between related parties *not* under common control (or under common control but practical expedient not elected)**

As noted above, Topic 842 specifies these leases should be accounted for based on their *enforceable* terms and conditions. Therefore, we do not believe amounts should be allocated to separate lease and non-lease components that exceed the amounts to which the lessee is legally obligated (the lessor is legally entitled) for those components. This applies even if the resulting allocations are uneconomical or clearly designed to achieve a particular accounting outcome (e.g. a smaller lease liability).

In contrast, if the enforceable amounts for each component cannot be determined (e.g. the contract is enforceable only as a whole), then we believe the entity should allocate the consideration in the contract on a relative stand-alone (selling) price basis.

#### **Lease is between related parties under common control and the terms and conditions practical expedient is elected**

Topic 842 specifies that these leases are classified and accounted for based on their *written* (instead of *enforceable*) terms and conditions. Therefore, because allocation of the consideration in the contract is an integral aspect of lease accounting under Topic 842, we believe amounts should be allocated to separate lease and non-lease components on the basis of the amounts to which the lessee is obligated (the lessor is entitled) for those components in accordance with the written terms and conditions between the parties. This applies even if the resulting allocations are uneconomical or clearly designed to achieve a particular accounting outcome (e.g. a smaller lease liability).

In contrast, if the written terms and conditions do not specify the amounts owed (entitled) for each component, then we believe the entity should allocate the consideration in the contract on a relative stand-alone (selling) price basis.



### Question 4.4.70

#### **Stand-alone selling price for CAM provided by the lessor at a loss**

#### **Should a lessor providing CAM at a loss include a profit margin when determining the stand-alone selling price for CAM?**

**Interpretive response:** Yes. While CAM may be provided at a loss by real estate lessors, the stand-alone selling price (i.e. 'the price at which an entity would sell a promised good or service separately to a customer') of CAM would generally not be such that it would result in a loss.

An entity providing CAM (or the services underlying CAM) would not sell such services separately at a loss. Therefore, even if the loss-based CAM pricing is stipulated in the contract, and even if other lessors similarly price their CAM in bundled lease arrangements, the stand-alone selling price for CAM based on the guidance in Topic 606 would differ from that contractually stated amount. In general, where CAM is provided at a loss, the economics of the lease arrangement are that the rental payment subsidizes CAM (in the form of a higher rental payment).

By applying the guidance in Topic 606 on determining stand-alone selling prices and allocating the transaction price to these lease arrangements, lessors may allocate more revenue to CAM and less revenue to the lease component than they did under Topic 840.



#### Comparison to legacy US GAAP

##### **Separating lease from non-lease components**

4.4.160 Topic 842 and Topic 840 are generally consistent with respect to accounting for non-lease components (or elements) separately from lease components. For example, Topic 840, like Topic 842, required 'substantial services' (i.e. in general, most services other than routine maintenance) or goods, such as consumables, provided by the lessor to be accounted for separately from the lease elements of a contract. However, unlike Topic 842, Topic 840 did not permit entities to not separate substantial service elements from the lease element to which they related. [840-10-15-19]

4.4.170 The guidance in Topic 842 with respect to separating lease from non-lease components of a contract is significantly more consequential to a lessee's accounting than the similar guidance in Topic 840. This is because while operating lease elements and service elements are accounted for similarly under Topic 840, lease components are subject to substantially different accounting requirements (i.e. the recognition of lease assets and lease liabilities) under Topic 842 than non-lease components.

### **Determining the stand-alone (selling) price of components and allocating consideration**

4.4.180 The requirements of Topic 842 differ from those in Topic 840 in the following key respects.

- Under Topic 842, executory costs that do not transfer a good or service to the customer (e.g. payment of the lessor's property taxes or insurance) are allocated to both the lease and the non-lease components of the contract on the same basis as the other consideration in the contract. Under Topic 840, all executory costs are considered related to the lease element.
- While the relative fair value allocation method under Topic 840 was substantially the same as the relative stand-alone price allocation method applicable to lessees under Topic 842, additional rigor is prescribed for determining the stand-alone price of the components of the contract.

For example, in no case does Topic 842 permit an entity to default to amounts specified in the contract when determining the stand-alone price for a component. An entity determines the stand-alone (selling) price of a lease or a non-lease component based on its observable stand-alone (selling) price (if readily available), and estimated stand-alone (selling) prices if observable prices are not readily available. Contractually stated amounts for lease or non-lease payments should not be presumed to represent the stand-alone (selling) price for a component.

Consistent with the discussion in Question 4.4.70, the allocation requirements in Topic 842 may result in different allocations between components than occurred under Topic 840. [840-10-15-19]

## **4.4.2 Allocate variable consideration in the contract – lessor**

4.4.190 If variable payments are included in the consideration in the contract (see section 4.3) for a lessor, they are allocated entirely to the non-lease component(s) to which they relate if that would be consistent with the transaction price allocation objective in Topic 606. [842-10-15-39]

#### **Transaction price allocation objective**

The objective when allocating the transaction price is for an entity to allocate the transaction price to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer. [606-10-32-28]

4.4.200 If the lessor does not allocate those variable payments entirely to the non-lease component(s) to which they relate, it allocates them on the same basis as the remainder of the consideration in the contract. [606-10-32-39]



### Example 4.4.30

#### **Allocating the consideration in the contract – observable and estimated stand-alone (selling) prices (2)**

This example is a continuation of Example 4.3.10, which illustrated how to measure the consideration in the contract in three scenarios. This example takes the consideration that was calculated for the *lessor*, and allocates it to components following the guidance in Topic 606.

In all three scenarios, it is assumed the stand-alone selling prices are \$315,000 (equipment) and \$40,000 (maintenance), and Lessor LR has not elected the non-separation practical expedient in paragraphs 4.4.51 – 4.4.56.

##### **Scenario 1: Variable payments not based solely on non-lease component**

Lessee LE and Lessor LR enter into a three-year lease of equipment that includes maintenance services on the equipment throughout the lease term. LE will pay LR:

- a fixed payment of \$110,000 per year; and
- a variable payment of \$7,700 each year that the equipment is operating a minimum number of hours at a specified level of productivity (i.e. the equipment is not malfunctioning or inoperable).

In Example 4.3.10, Scenario 1, the consideration in the contract was measured at \$330,000, which excluded any variable payments. LR allocates the consideration in proportion to stand-alone selling prices as follows.

Component	Stand-alone selling price	Allocation	Calculation
Equipment lease	\$315,000	\$292,817	$(315,000 / 355,000) \times 330,000$
Maintenance	40,000	37,183	$(40,000 / 355,000) \times 330,000$
	<b>\$355,000</b>	<b>\$330,000</b>	

##### **Scenario 2: Variable payments that specifically relate to a non-lease component – allocation to lease and non-lease components**

Changing the facts of Scenario 1, the maintenance services are highly specialized and no entity would expect the equipment to meet the specified performance metrics without the related maintenance services.

In Example 4.3.10, Scenario 2, the consideration in the contract was measured at \$353,100, which included \$23,100 of variable payments related to the maintenance (non-lease) component.

Next, following the allocation objective in Topic 606 (see paragraph 4.4.190), LR considers whether allocating the entire variable amount of \$23,100 to the maintenance component would depict the amount of consideration to which LR expects to be entitled in exchange for providing the lease and maintenance services to LE. If it does, total consideration would be allocated in one of the two following ways.

**Approach 1**

Component	Stand-alone selling price	Allocation	Calculation
Equipment lease	\$315,000	\$292,817	$(315,000 / 355,000) \times 330,000$
Maintenance	40,000	60,283	$((40,000 / 355,000) \times 330,000) + 23,100$
	<b>\$355,000</b>	<b>\$353,100</b>	

**Approach 2**

Component	Stand-alone selling price	Allocation	Calculation
Equipment lease	\$315,000	\$330,000	All fixed consideration
Maintenance	40,000	23,100	Only variable consideration
	<b>\$355,000</b>	<b>\$353,100</b>	

However, in this Scenario, LR concludes that allocating \$60,283 (or \$23,100) to the maintenance services would not depict the consideration to which LR expects to be entitled for each component. This is because these two amounts are significantly higher (lower) than the amount to which LR expects to be entitled for the maintenance services.

LR allocates the total consideration in proportion to the components' stand-alone selling prices as follows.

Component	Stand-alone selling price	Allocation	Calculation
Equipment lease	\$315,000	\$313,314	$(315,000 / 355,000) \times 353,100$
Maintenance	40,000	39,786	$(40,000 / 355,000) \times 353,100$
	<b>\$355,000</b>	<b>\$353,100</b>	

Alternatively, consistent with Lessor LR's allocation of the consideration in the contract between the lease component and the CAM in Example 4.2.40, we believe the following allocation would also be acceptable in this scenario:

Component	Stand-alone selling price	Allocation	Calculation
Equipment lease	\$315,000	\$313,197	$(315,000 / 331,900^1) \times 330,000$
Maintenance	40,000	39,903	$((16,900 / 331,900) \times 330,000) + 23,100$
	<b>\$355,000</b>	<b>\$353,100</b>	

Note:

- The total of the stand-alone selling prices used in the calculations (\$331,900) has been adjusted to remove the \$23,100 that has already been specifically allocated to the non-lease maintenance component (\$355,000 – \$23,100).

Either allocation method illustrated results in approximately 89% of the consideration in the contract being allocated to the lease component and approximately 11% being allocated to the maintenance non-lease component.

### **Scenario 3: Variable payments that specifically relate to a non-lease component – allocation only to non-lease component**

Changing the facts of Scenario 2, LE will pay LR:

- a fixed payment of \$102,700 per year; and
- a variable payment of \$15,000 each year that the equipment is operating a minimum number of hours at a specified level of productivity.

In Example 4.3.10, Scenario 3, the consideration in the contract was measured at \$338,100, which included \$30,000 of variable payments related to the maintenance (non-lease) component.

Next, LR concludes that allocating the entire variable amount of \$45,000 to the maintenance component (full value of the estimated variable payments, without consideration of the constraint on variable consideration) and the entire fixed amount of \$308,100 to the lease would reasonably depict the amount of consideration to which LR expects to be entitled in exchange for providing the lease and maintenance services to LE. The \$308,100 and the \$45,000 approximate the stand-alone selling prices of the lease (\$315,000) and the maintenance services (\$40,000), respectively.

Because the variable payments are allocated entirely to the maintenance services, if the consideration in the contract changes because LR concludes it is now probable that it will earn the full \$45,000 in variable payments, that change is allocated entirely to the maintenance services component.



### **Example 4.4.40 Percentage rent in a real estate lease**

*This example assumes that Lessee LE and Lessor LR have not elected the non-separation practical expedients in paragraphs 4.4.30 – 4.4.50 and paragraphs 4.4.51 – 4.4.56, respectively.*

Lessee LE and Lessor LR enter into a five-year lease for LE to be an anchor tenant at a regional mall.

The lease does not require LE to pay LR any fixed payments. Rather, LE will pay percentage rent to LR equal to 5% of the first \$2,000,000 in gross annual sales, and 7% on any sales in excess of \$2,000,000 during the period.

LE will also reimburse LR for its portion of LR's actual property tax assessments and building insurance costs during the lease term and its share of LR's CAM costs. LR estimates LE's portion of LR's costs of property taxes and building insurance to be approximately \$20,000 per year. LR estimates LE's portion of LR's CAM costs to be \$10,000 per year.

#### **Lessee**

LE does not include the variable payments in the consideration in the contract. This is because the payments do not depend on an index or rate, and are not in-

substance fixed because the variable terms have economic substance – i.e. they exist as a substantive way for LE and LR to share in the risks and benefits from use of the retail space – and create genuine variability in the lease payments to be made. This is true even if LE and LR can reliably forecast LE's annual sales for purposes of estimating the percentage rent (see Example 5.4.80).

Therefore, the consideration in the contract is \$0. LE will not recognize an ROU asset or lease liability at lease commencement.

### **Lessor**

LR starts with the amount of consideration determined in the same way as LE (\$0).

Next, LR considers the link between the variable payments of \$50,000 ( $\$10,000 \times 5$ ) and the performance of CAM. LR concludes that the variable payments relate specifically to an outcome dependent on LR's satisfactory performance of CAM (non-lease component).

Next, LR applies the variable consideration requirements in Topic 606 to calculate the amount that should be included in the consideration in the contract.

- a. LR estimates that the amount to which it expects to be entitled from variable payments for CAM is \$50,000.
- b. LR concludes that it is probable that including that amount in the consideration in the contract will not result in a significant revenue reversal to the cumulative revenue recognized under the contract when the uncertainty is resolved.

Therefore, the consideration in the contract is \$50,000.

LR does not include estimated payments related to percentage rent or property taxes and building insurance reimbursements in the consideration in the contract. This is because these payments represent variable payments specifically or partially related to the lease component that do not depend on an index or rate.

LR will recognize these variable payments related to percentage rent and property tax and building insurance reimbursements as earned – e.g. recognize percentage rent once LE's actual sales occur.

Next, applying the allocation objective in Topic 606 (see paragraph 4.4.190), LR considers whether allocating the entire variable amount of \$50,000 to CAM would be appropriate. The evaluation of whether the allocation objective is met should consider the resulting allocation to both the lease and CAM.

In this example, the allocation objective would not be met for the lease because the lease would receive no allocation of the consideration in the contract unless a portion of the \$50,000 is allocated to it. This is true even if the \$50,000 is consistent with the stand-alone selling price for CAM.

Therefore, LR allocates the consideration in the contract of \$50,000 to the lease component and non-lease component based on their relative stand-alone selling prices. When LR's estimate of the amount to which it expects to be entitled for CAM changes from \$50,000, those changes are changes to the

consideration in the contract and will be allocated on the same basis as the \$50,000 was allocated to the lease and CAM initially (see Example 14 Case B in Subtopic 842-10). [842-10-55-153 – 55-156]



#### Question 4.4.80

#### **Lessor accounting for a supply agreement that includes a 'free' lease of equipment**

### **How does a lessor allocate the consideration in the contract and variable payments between goods and a 'free' lease of equipment with which the goods will be used?**

**Background:** A supplier of goods will frequently provide customers with related equipment for use with its goods for no stated consideration – i.e. the contract does not stipulate a fixed or variable payment expressly for the right to use the equipment. Rather, the customer pays only a per unit price for the applicable goods.

The following are examples.

- A supplier of chemicals or gases may provide its customers with the right to use storage tanks (or other containers) to store the chemicals or gases until their use by the customer for no stated consideration. The only consideration that will be paid by the customer is a per unit purchase price for the chemicals or gases.
- A supplier of medical devices and related consumables may provide its customers with the right to use a medical device, with which the customer may use only the supplier's consumables, for no stated consideration. The only consideration that will be paid by the customer is a per unit purchase price for the consumables.

Terms and conditions of the arrangement, and other facts and circumstances, can vary. The following are examples (not exhaustive).

- Some contracts include a minimum purchase volume, while others do not. Additionally, the minimum may be significant or minor compared to the total expected purchases by the customer under the contract.
- The supplier may sell the goods and/or the equipment separately – e.g. the goods may be sold separately to customers that previously purchased the equipment, and/or the equipment may be sold separately by the supplier to authorized dealers or resellers (and by them, separately to end customers).
- The price per unit of the goods sold may or may not be the stand-alone selling price of those goods when sold separately – e.g. to customers that previously purchased the supplier's equipment or other equipment with which the goods can be used.

Additionally, in these arrangements, the equipment can be either relatively inexpensive or more valuable.

**Interpretive response:** *This question should not be analogized to by customers (lessees). Customers' (lessees') accounting will depend on factors beyond*

*those in this Question, such as whether an enforceable minimum is cumulative (i.e. applies to the entire contract period) or periodic (e.g. the customer must purchase a specified number of goods each month, quarter or year during the contract period). It will generally never be appropriate for a customer (lessee) to allocate none of the consideration in the contract or variable payments to the equipment lease.*

We believe the answer to this question depends on the facts and circumstances.

### Contracts with mandatory minimum purchase volumes

If a contract as described in the background includes an enforceable minimum purchase volume of the goods, there is ‘consideration in the contract’ equal to the minimum amount of consideration the customer will pay the supplier to fulfill the minimum. Purchases above the minimum are ‘optional purchases’; see Question 5.3.10 and related examples in KPMG Handbook, [Revenue recognition](#).

The supplier must consider whether there is a material right related to the customer option to make purchases above the enforceable minimum; if so, the material right is a non-lease component of the contract. However, there would generally not be a material right if the per unit price for the optional purchases is the same as or more than the per unit price for the units that comprise the minimum.

Chapter 8 of KPMG Handbook, [Revenue recognition](#), discusses identifying and accounting for material rights. The remainder of this interpretive response assumes there is not a material right in the contract.

Depending on the facts and circumstances, we believe the supplier (lessor) should apply one of two methods to account for the contract. The example that follows this question (Example 4.4.45) illustrates both methods.

#### Minimum purchase method

- **Step 1.** The supplier allocates the consideration in the contract (e.g. \$100,000, based on a 10,000-unit purchase minimum at \$10/unit) to the lease and the minimum purchase quantity based on the stand-alone selling prices of each. The ‘lease payments’ equal the portion of the consideration in the contract allocated to the lease.
- **Step 2.** The supplier accounts for the lease, including recognition of lease revenue, in accordance with Subtopic 842-30 (see chapter 7), and recognizes revenue related to the promised goods in accordance with Topic 606.
- **Step 3.** Customer orders for optional goods above the purchase minimum are accounted for separately from the initial contract including the lease and the purchase minimum. Consequently, the consideration for those orders is allocated entirely to the optional goods ordered – i.e. none of the consideration from those orders is allocated to the ongoing lease.

Under this method (unlike the total estimated purchases method), the supplier does not need to estimate total expected customer purchases under the contract, and there is no *variable* lease revenue earned by the supplier.

We do not believe this method is appropriate if the amount that would be allocated to the lease is inconsistent with the Topic 606 allocation objective (see paragraph 4.4.190) – e.g. it is an uneconomical amount. In that case, the lessor should use the total estimated purchases method. See discussion below about using the minimum purchase method when the contract does not include a mandatory minimum purchase volume.

We believe the minimum purchase method is more likely to yield an acceptable result if the minimum purchase amount is a substantial (not minor) portion of the total expected purchases of goods by the customer under the contract.

#### **Total estimated purchases method**

- **Step 1.** The supplier allocates the consideration in the contract (calculated in the same way as under the minimum purchase method) to the lease and the *total* expected purchase quantity (rather than the *minimum* purchase quantity) based on the stand-alone selling prices of each. The ‘lease payments’ equal the portion of the consideration in the contract allocated to the lease, which will be less than what is allocated to the lease under the minimum purchase method, because the total expected purchase quantity generally will exceed the minimum purchase quantity (see Example 4.4.45).
- **Step 2.** The supplier accounts for the lease, including recognition of lease revenue, in accordance with Subtopic 842-30 (see chapter 7), and recognizes revenue related to the promised goods (i.e. the committed minimum) in accordance with Topic 606.
- **Step 3.** Customer orders for optional goods above the purchase minimum are not accounted for separately. Because the original allocation of the consideration in the contract contemplated customer orders above the purchase minimum, and therefore allocated less consideration to the lease, the consideration from each order is allocated to the lease and the goods ordered on the same basis as the consideration in the contract was allocated originally.
- **Step 4.** Amounts allocated to the lease under the optional goods orders are accounted for as variable lease payments. The amount allocated to the goods in each order is the Topic 606 ‘transaction price’ for those goods and is recognized in accordance with Topic 606.

We believe the total estimated purchases method is acceptable under any circumstance – i.e. regardless of whether the minimum purchase volume is a substantial or minor portion of the customer’s total expected purchase volume. In circumstances where use of the minimum purchase method would yield a result that is inconsistent with the Topic 606 allocation objective, we believe the total estimated purchases method must be used. See discussion below about using the minimum purchase method when the contract does not include a mandatory minimum purchase volume.

#### **Contracts without mandatory minimum purchase volumes**

Based on discussions with the FASB and SEC staffs about contracts of this nature, in general we believe that when the contract does not include a minimum purchase volume requirement, the supplier should use the total estimated purchases method.

Applying the total estimated purchases method to these contracts will differ from its application to contracts that include a minimum purchase volume. This is because the contract will include no 'consideration in the contract'. Therefore, in effect, only Steps 3 and 4 of the total estimated purchases method will apply.

In limited circumstances, the minimum purchase method may be acceptable. Based on our discussions with the FASB and SEC staffs, this method, which would result in no allocation of payments stemming from the customer's orders for the supplier's goods to the lease, would be appropriate only when both:

- a. the lease is insignificant in value, such that the customer would effectively view the lease as a 'convenience', rather than a valuable aspect of the contract; and
- b. there is objective evidence that the price for the goods available for purchase under the contract is the stand-alone selling price for those goods. In other words, the price offered for the goods is the observable stand-alone selling price of the goods when sold separately to customers that are not leasing the supplier's equipment, such as customers that previously purchased the supplier's equipment or another vendor's equipment with which the supplier's goods can be used.

While not expressly stated by the staffs, it appears to be their view that when these criteria are met, allocating no consideration from the customer's goods orders to the lease would not be inconsistent with the Topic 606 allocation objective – i.e. it would not be an uneconomical reflection of the transaction.

Related to criterion (a), based on our discussions with the FASB and SEC staffs, we believe:

- This requirement would be met only if the underlying asset is inexpensive – i.e. has an insignificant fair value – such that the stand-alone selling price of the lease is insignificant. In other cases (e.g. if the asset is an expensive piece of medical equipment, for which the stand-alone selling price of a lease thereof would be more than insignificant), it would not be reasonable to ascribe no economic value to the lease, regardless of the price for the goods offered under the contract.
- Significance in the context of this criterion is not determined on a relative basis – i.e. the stand-alone selling price of the lease relative to the stand-alone selling price of the total expected consumable purchases. In other words, it is not relevant to the evaluation of this criterion whether the portion of the total expected payments that would be allocated to the lease is insignificant in relation to the customer's total expected payments under the contract.



#### Example 4.4.45

#### **Supply agreement with no stated consideration for the lease**

Supplier, a chemical manufacturer, enters into a supply agreement with Customer to sell chemicals (Chemical) over a five-year period.

As part of the agreement, Supplier provides a storage tank to Customer for storing and using Chemical during the same period. The contract stipulates that the storage tank is provided at no additional charge. Supplier retains title to the storage tank. At the end of the five years, the storage tank will be returned to Supplier.

Under the contract, Customer is required to make minimum purchases each year and must pay a penalty if its actual purchases do not meet the required minimum. There is not a material right in the contract because the unit pricing for Chemical is the same throughout the contract period.

The following additional facts are relevant.

Minimum purchase requirement:	22,500 units per year (112,500 total)
Expected purchases:	30,000 units per year (150,000 total)
Contract price of Chemical:	\$2.50/unit
Penalty for failing to reach the minimum purchase requirement:	\$0.20/unit of shortfall
Stand-alone selling price of the storage tank lease:	\$18,000
Renewal options:	None
Storage tank purchase option:	None
Remaining economic life of the storage tank:	10 years
Fair value of the storage tank:	\$22,500
Lessee or third-party residual value guarantees:	None

Supplier determines that the penalty is substantive, and therefore the minimum purchase requirement is deemed to be enforceable. In addition, Supplier concludes that \$2.50/unit is the stand-alone selling price of Chemical in other contracts.

To account for the arrangement, Supplier must determine how to allocate the consideration in the contract and variable payments between the lease component (i.e. the right to use the storage tank) and the non-lease component (i.e. purchases of Chemical).

### Approach 1: Minimum purchase method

Supplier determines that the minimum purchase method is acceptable because the total allocation to the lease is reasonable when considered against the Topic 606 allocation objective. That is, as illustrated below, the total lease revenue that will be recognized is in line with the stand-alone selling price for the lease.

#### Step 1

The consideration in the contract is based on the minimum purchase volume. This results in total consideration in the contract of \$281,250 (112,500 units × \$2.50/unit). This amount is allocated to the storage tank and the minimum purchase quantity of Chemical based on their stand-alone selling prices.

Component	Units	Stand-alone selling price	Total stand-alone selling price	Allocation	Calculation
Storage tank	1	\$18,000	\$ 18,000	\$ 16,917	(18,000 / 299,250) × 281,250
Units of Chemical	112,500	\$2.50	281,250	264,333	(281,250 / 299,250) × 281,250
					<b>\$299,250      \$281,250</b>

### Step 2

Supplier recognizes total lease revenue of \$16,917 on a straight-line basis over the five-year lease term (\$3,383 per year) because the lease is classified as an operating lease. Supplier recognizes product revenue by allocating a transaction price of \$2.35 (\$264,333 / 112,500 units) to each unit of Chemical as it is sold until the minimum purchase requirement is met.

### Step 3

Once the minimum purchase requirement of 112,500 units is met, the consideration for additional orders is allocated entirely to the optional purchases of Chemical. Therefore, the transaction price for these optional purchases is \$2.50 per unit. No variable lease revenue is recognized by Supplier.

Description	Allocation	Calculation
Straight-line operating lease revenue recognized over five years	\$ 16,917	112,500 units × [(18,000 / 299,250) × \$2.50]
Topic 606 revenue recognized for units of Chemical sold against the minimum purchase requirement	264,333	112,500 units × [(281,250 / 299,250) × \$2.50]
Topic 606 revenue recognized on optional Chemical purchases above the minimum	93,750	37,500 units × \$2.50
		<b>\$375,000</b>

### Approach 2: Total estimated purchases method

#### Step 1

The consideration in the contract is still based on the minimum purchase requirement because those purchases represent the fixed payments in the contract. Therefore, the consideration in the contract is \$281,250 (112,500 units × \$2.50/unit).

However, this consideration is allocated to the storage tank and the total expected purchase quantity (rather than the minimum purchase quantity) based on their stand-alone selling prices.

Component	Units	Stand-alone selling price	Total stand-alone selling price	Allocation	Calculation
Storage tank	1	\$18,000	\$ 18,000	\$ 12,882	$(18,000 / 393,000) \times 281,250$
Units of Chemical	150,000	\$ 2.50	375,000	268,368	$(375,000 / 393,000) \times 281,250$
<b>\$299,250</b>					<b>\$281,250</b>

### Step 2

Supplier recognizes operating lease revenue of \$12,882 on a straight-line basis over the five-year lease term (\$2,576 per year) because the lease is classified as an operating lease. Supplier recognizes product revenue by allocating a transaction price of \$2.39 (\$268,368 / 112,500 units) to each unit of Chemical as it is sold.

### Step 3

The original allocation of the consideration in the contract contemplated additional orders above the purchase minimum, and therefore allocated less consideration to the lease. As a result, the consideration from each order is allocated to the storage tank and purchases of Chemical on the same basis as the consideration in the contract was allocated originally – i.e. \$2.39 to each unit of Chemical purchased and the remaining \$0.11 to the storage tank.

### Step 4

Amounts allocated to the lease from optional purchases of Chemical above the purchase minimum in Step 3 are accounted for as variable lease payments. The amount allocated to the units of Chemical in each such order is the Topic 606 ‘transaction price’ for each unit of Chemical. Total amounts recognized for each component are as follows.

Description	Allocation	Calculation
Straight-line operating lease revenue recognized over five years	\$ 12,882	$112,500 \text{ units} \times [(18,000 / 393,000) \times \$2.50]$
Topic 606 revenue recognized for units of Chemical sold against the minimum purchase requirement	268,368	$112,500 \text{ units} \times [(375,000 / 393,000) \times \$2.50]$
Topic 606 revenue recognized on optional Chemical purchases above the minimum	89,456	$37,500 \text{ units} \times [(375,000 / 393,000) \times \$2.50]$
Variable lease revenue arising from optional Chemical purchases above the minimum	4,294	$37,500 \text{ units} \times [(18,000 / 393,000) \times \$2.50]$
	<b>\$375,000</b>	



## Comparison to legacy US GAAP

### Allocation differences

4.4.210 The transaction price allocation guidance in Topic 606 that must be applied by lessors will not always result in an allocation of the consideration in the contract consistent with the relative fair value allocation method in Topic 840. In some cases, the lessor allocation guidance in Topic 842 will allocate a discount or variable consideration entirely to only one or some of the components of the contract, rather than on a relative basis. [840-10-15-19, 606-10-32-37, 32-40]

### 4.4.3 Variable payments not included in the consideration in the contract

4.4.220 Following from the discussion of Step 3 (see section 4.3), variable payments not included in the consideration in the contract are generally allocated to the lease and/or non-lease components consistent with the allocation decisions made in Step 4.

4.4.221 A lessee recognizes these variable payments in the income statement when (or as) incurred.

4.4.222 A lessor recognizes the portion of such variable payments allocated to: [842-10-15-40, 842-10-55-152]

- the separate lease component as revenue in the period in which the changes in facts and circumstances on which those payments are based occur; and
- the non-lease component(s) as revenue when the requirements of the applicable Topic (e.g. Topic 606) are met.

4.4.223 Recognition of variable lease payments not included in the consideration in the contract is addressed in sections 5.4, 6.4 (lessees) and 7.3 – 7.4 (lessors). [842-10-15-35, 15-40, 55-150 – 55-152, 842-20-25-5 – 25-6, 55-1 – 55-2, 842-30-25-2, 25-9, 25-11]



### Observation

#### Variable payments of lessor costs made directly to a third party recognized net by lessors

4.4.224 As outlined in section 4.2.1, lessor costs (i.e. costs incurred by the lessor in its role as lessor or as owner of the underlying asset, such as property taxes and insurance costs) and variable payments thereof made by a lessee directly to the relevant third party (e.g. taxing authority or insurer) are recognized on a net basis *by the lessor*. [ASU 2018-20.BC14]

4.4.225 Neither the costs nor the lessee's payments are reflected in the lessor's income statement, regardless of whether the lessor knows, can readily determine or can reliably estimate the cost paid by the lessee. Therefore, the

guidance in paragraph 4.4.222 applies only when a lessee's variable payments of lessor costs are made to the lessor. [842-10-15-40A]



### Example 4.4.50

#### Variable lease payments not included in the consideration in the contract

*This example assumes that Lessee LE and Lessor LR have not elected the non-separation practical expedients in paragraphs 4.4.30 – 4.4.50 and paragraphs 4.4.51 – 4.4.56, respectively.*

Lessee LE leases a specifically identified space in a building and a printing press from Lessor LR for three years.

The following additional facts are relevant.

- LE and LR each conclude that the building space and the printing press are separate lease components.
- The contractual lease payments for the building space are fixed at \$300,000 per year, which is considered to be a market rate.
- The contractual lease payments for the printing press are based entirely on the level of usage, at \$50 for each hour operated, which is considered to be a market rate.
- LE and LR each predict that the printing press will be operated for 2,000 hours per year over the three-year lease term, resulting in total expected variable payments of \$300,000 over the three-year lease term.
- There are no non-lease components of the contract, and the variable payments are not based on an index or rate. Therefore, the consideration in the contract is \$900,000 ( $\$300,000 \times 3$ ) for LE and LR, and all of the fixed payments are 'lease payments' (see section 5.4).

#### Lessee

LE allocates the lease payments of \$900,000 ( $\$300,000 \times 3$ ) to the two lease components as follows.

Component	Stand-alone price	Allocation	Calculation
Building space	\$ 900,000	\$675,000	$(900,000 / 1,200,000) \times 900,000$
Press	300,000	225,000	$(300,000 / 1,200,000) \times 900,000$
	<b>\$1,200,000</b>	<b>\$900,000</b>	

LE recognizes the variable lease cost as incurred, and each variable amount that will be paid is allocated between the building space lease and the printing press lease in the same proportion as the lease payments were originally allocated – 75% to the building space lease and 25% to the printing press lease. This means that if the total variable lease payments ultimately owed by LE are \$300,000, they will have been allocated as follows over the term of the lease.

Component	Stand-alone price	Allocation	Calculation
Building space	\$ 900,000	\$225,000	(900,000 / 1,200,000) × 300,000
Press	300,000	75,000	(300,000 / 1,200,000) × 300,000
	<b>\$1,200,000</b>	<b>\$300,000</b>	

### Lessor

LR allocates the \$900,000 in fixed lease payments entirely to the building space lease and the \$300,000 in expected variable lease payments entirely to the printing press lease.

LR concludes this is appropriate because:

- the variable amounts relate specifically to LE's use of the printing press; and
- this allocation of the fixed and variable lease payments to the building space lease and the printing press lease reasonably depicts the amounts to which LR expects to be entitled for each lease component – i.e. this allocation meets the transaction price allocation objective in Topic 606 (see paragraph 4.4.190).

The lease payments used by LR in its evaluation of the lease classification and in accounting for the printing press lease are nil because only variable lease payments are allocated to that lease component.

LR recognizes the variable payments when they are earned, which is when/as LE's usage of the printing press occurs, and each variable amount earned is allocated entirely to the printing press lease.

## 4.5 Subsequent changes to the consideration in the contract



### Excerpt from ASC 842-10

- > Lessee

**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).

- > Lessor

**15-41** A lessor shall remeasure and reallocate the remaining consideration in the contract when there is a contract modification that is not accounted for as a separate contract in accordance with paragraph 842-10-25-8.

**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.

## 4.5.1 Lessee

4.5.10 Lessees remeasure and reallocate the consideration in the contract when: [842-10-15-36]

- there is a remeasurement of the lease liability – e.g. a change in the *lease payments* resulting from a change in the lease term or a change in the amount probable of being owed under a residual value guarantee; or
- there is a contract modification that is not accounted for as a separate contract.

4.5.20 The accounting for changes in consideration in the contract from the lessee's perspective is discussed in sections 6.6 and 6.7.

## 4.5.2 Lessor

4.5.30 Lessors remeasure and reallocate the consideration in the contract only when a contract modification occurs that is not accounted for as a separate contract (see section 7.6). [842-10-15-41]

4.5.40 Changes in the consideration in the contract not resulting from a modification are accounted for in accordance with the changes in the transaction price guidance in Topic 606. An example is changes in the lessor's estimate of variable payments to which it will be entitled specifically for a non-lease component or changes in the estimated amount that are unconstrained. [842-10-15-42, 606-10-32-42 – 32-45]

4.5.50 In most cases, changes in the consideration in the contract will be allocated to the separate lease and non-lease components of the contract on the same basis as was done initially. For example, if a variable payment was allocated entirely to a non-lease component initially, a change to the consideration in the contract resulting from a change in the estimate of that variable payment will generally be allocated entirely to the non-lease component. Similarly, if the consideration in the contract was allocated proportionally on a relative stand-alone selling price basis, changes will generally also be allocated in that manner. However, in some cases, changes may be allocated to only one (or some) of the components of the contract.

Example 4.4.30, Scenario 3 describes how the lessor will account for a change in the consideration in the contract – i.e. a change resulting from estimated amounts becoming unconstrained.



### Question 4.5.10

#### **Variable payments that do not depend on an index or rate and the consideration in the contract**

**Do variable payments that do not depend on an index or rate change the consideration in the contract when they become fixed?**

**Interpretive response:** For lessees, no. Variable payments that do not depend on an index or a rate, even when they are incurred, do not change (i.e. become part of) the consideration in the contract.

For lessors, variable payments that do not depend on an index or rate change (i.e. become part of) the consideration in the contract when the variable payment specifically relates to a non-lease component (or to an outcome resulting from transferring or providing a non-lease component) (see paragraph 4.3.50). That is, when the changes in facts and circumstances on which the variable payment is based occur, the consideration in the contract changes.

In contrast, variable payments that do *not* specifically relate to a non-lease component (or to an outcome resulting from transferring or providing a non-lease component) never change the consideration in the contract (absent a contract modification not accounted for as a separate contract) – even when they become fixed (i.e. when the changes in facts and circumstances on which the variable payment is based occur).

This distinction between what does and does not change the consideration in the contract matters for lessors because there is specific guidance in Topic 606 applicable to changes in the ‘transaction price’ that lessors are required to consider when there are changes to the consideration in the contract. That specific guidance does not apply to variable payments that are not part of the consideration in the contract. [842-10-15-42]



### Observation

#### **Allocating subsequent changes to the consideration in the contract after a modification or remeasurement**

4.5.60 While not explicitly stated, we believe the Board intended that if the consideration in the contract has been reallocated as a result of a contract modification or remeasurement of the lease liability, changes to the consideration in the contract subsequent to the reallocation resulting from the modification or remeasurement should be allocated on the same basis as the most recent reallocation.

## 4.6 Combining two or more contracts



### Excerpt from ASC 842-10

#### 25 Recognition

##### General

> Contract Combinations

**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:

- The contracts are negotiated as a package with the same commercial objective(s).
- The amount of consideration to be paid in one contract depends on the price or performance of the other contract.
- The rights to use **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.

4.6.10 Two or more contracts (at least one of which is or contains a lease) entered into at or near the same time with the same counterparty (or related party) are combined as a single transaction if: [842-10-25-19]

- the contracts are negotiated as a package with a single commercial objective;
- the amount of consideration to be paid in one contract depends on the price or performance of the other contract; or
- the leases in the contracts (or some of the leases) are a single lease component.



#### Question 4.6.10

**'At or near the same time'**

#### What constitutes 'at or near the same time' when evaluating whether two or more contracts should be combined?

**Interpretive response:** Topic 842 does not provide a bright line for evaluating what constitutes at or near the same time to determine whether two or more contracts should be combined. We believe an entity should consider its customary business practices and other reasonable expectations, such as recent changes to contracting practices, in evaluating whether two or more contracts have been entered into at or near the same time.

For example, a lessor may perform services for a significant portion of its lessee customers and generally enter into separately papered contracts for those

services. In that case, the entity might consider the period of time that generally elapses between the initiation of the lease contract and the initiation of the services contract in determining what represents a *minimum* period of time within which the entity would conclude two or more contracts were entered into at or near the same time.

An entity should also have processes in place that consider specific facts and circumstances in cases that may not be 'customary' or usual. For example, an entity should not ignore the fact that two non-standard agreements – i.e. that are different from or larger than its typical arrangements – were being discussed or negotiated over the same period of time and would appear to be significantly interrelated solely because they were not executed within its established 'minimum period' used to determine generally whether two or more contracts were entered into at or near the same time.

An entity should establish procedures to ensure multiple contracts initiated with the same customer at or near the same time are identified on a timely basis, and therefore appropriately considered as to whether they should be accounted for as a single contract.



#### Question 4.6.20

#### Different divisions or business units

**If the entity (lessee or lessor) and/or the counterparty have multiple divisions (or business units), should contracts entered into between different divisions be evaluated for possible combination?**

**Interpretive response:** Yes. There is no exception for considering whether two or more contracts should be combined because they were executed by different divisions of the entity and/or the counterparty. However, whether the contracts were negotiated by the same parties, or instead were negotiated with different divisions of the entity or the counterparty may significantly influence whether any of the three specified criteria in paragraph 4.6.10 are met. For example, two contracts entered into by different divisions of one or both parties *may* be less likely to have been 'negotiated as a package with a single commercial objective' or to have multiple leases that are a single lease component.



#### Example 4.6.10

#### Combination of contracts

Lessee LE leases a specifically identified space in a building and a printing press from Lessor LR for three years. The following additional facts are relevant.

- LR leases the building space and printing press to LE in two separate contracts, executed within a few calendar days of each other.

- The contractual lease payments for the building space are fixed at \$250,000 per year, compared to an estimated market rate of \$300,000 per year.
- There are no non-lease components of the building contract and the variable payments are not based on an index or a rate. Therefore, the consideration in the contract is \$750,000 ( $\$250,000 \times 3$ ) for LE and LR, and all of the fixed payments are lease payments (see section 5.4).
- The contractual lease payments for the printing press are entirely based on the level of use (\$75 for each hour operated), compared to an estimated market rate of \$50 for each hour operated.
- LE and LR each predict that the printing press will be operated for 2,000 hours per year over the three-year lease term, giving total expected variable payments of \$450,000 over the three-year lease term.
- Total expected fixed and variable consideration is \$1,200,000 over the three-year lease term. However, the stated \$250,000 per year for the building space lease is a below market rate, and the \$75 per hour variable payment for using the printing press is considered to be an above market rate. LR agrees to a lower fixed payment to incentivize LE, with the expectation of making up the difference with the above market variable payments.

In this example, the contracts should be combined and considered a single contract for the purpose of applying Topic 842. This is because the two contracts are executed near the same time, and together they fulfill a single commercial objective. As noted, LR agrees to a lower fixed payment in the first contract to incentivize LE, with the expectation of making up the difference with the above market variable payments in the second contract.



## Observation

### Combining two or more contracts

#### **Allocation of consideration in a combined contract**

4.6.20 A combined contract (i.e. one comprising two or more separately papered contracts) may have multiple lease (and potentially non-lease) components. In this scenario, it is likely that the allocation of the consideration in the combined contract will be different from the stated consideration in the original, separately papered contracts.

#### **Aligning contract combinations guidance in Topic 842 and Topic 606**

4.6.30 Consistent with its rationale for a number of other decisions in developing Topic 842, the Board concluded that, particularly for lessors, there would be a significant benefit to substantially aligning the guidance on combining contracts in Topic 842 to that in Topic 606. Because many contracts contain components that will be in the scope of both Topics, coming to generally consistent conclusions as to when two or more contracts should be combined will reduce complexity for lessors. [\[ASU 2016-02.BC165–BC167\]](#)

4.6.40 While the contract combinations guidance will be familiar to most entities because of its similarity to the contract combinations guidance in Topic 606,

there will be some judgment involved in determining when two contracts must be combined. This judgment includes, but is not limited to, determining:

- what 'at or near the same time' means – some entities have interpreted that to mean within 90 days or within the same fiscal quarter or reporting period when applying that notion to other situations;
- when two or more contracts have the same commercial objective; and
- when consideration to be paid in one contract is dependent on the consideration to be paid in another.

4.6.50 These judgments are not unique to the contract combinations guidance in Topic 842 and Topic 606. Similar judgments were required in the legacy US GAAP revenue recognition guidance – e.g. within Subtopic 605-25 (multiple-element arrangements) and Subtopic 985-605 (software revenue recognition) – such that judgments made historically may continue to be acceptable in applying the new guidance.

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# 5. Concepts and definitions for lessees and lessors

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## How the standard works

There are a number of key concepts and definitions that apply to both lessees and lessors that are integral to the guidance in Topic 842. The following are discussed in this chapter, as an introduction to the accounting in chapters 6 (lessees) and 7 (lessors).

Key concept or definition	Application in Topic 842
<b>Commencement date</b>	The date of initial recognition and measurement of a lease for lessees and lessors. In addition, lease classification is determined at lease commencement.
<b>Reasonably certain</b>	Determining whether a lessee is reasonably certain to exercise an option to either extend (or renew) a lease or purchase the underlying asset (or is reasonably certain <i>not</i> to exercise an option to terminate a lease) is integral to determining the 'lease term' and the 'lease payments'.
<b>Lease term</b>	The lease term is integral to determining: <ul style="list-style-type: none"> <li>— lease payments;</li> <li>— lease classification;</li> <li>— the measurement of lease assets and lease liabilities; and</li> <li>— whether the lease is a 'short-term' lease (for lessees).</li> </ul>
<b>Lease payments</b>	The lease payments are integral to determining: <ul style="list-style-type: none"> <li>— lease classification; and</li> <li>— the measurement of lease assets and lease liabilities.</li> </ul>
<b>Initial direct costs</b>	Initial direct costs affect: <ul style="list-style-type: none"> <li>— the discount rate for the lease, if the rate implicit in the lease is used; and</li> <li>— the measurement of lease assets and lease liabilities.</li> </ul>
<b>Discount rate for the lease</b>	The discount rate for the lease affects: <ul style="list-style-type: none"> <li>— lease classification; and</li> <li>— the measurement of lease assets and lease liabilities.</li> </ul>
<b>Economic life</b>	The total and remaining economic life of the underlying asset affects lease classification.
<b>Portfolio approach</b>	Topic 842 may be applied on a portfolio basis to similar leases if the entity reasonably expects that the outcome will not differ from applying the standard to the individual leases.
<b>Useful life</b>	The period over which an asset is expected to contribute directly or indirectly to future cash flows.

Key concept or definition	Application in Topic 842
<b>Probable (second definition)</b>	The <i>second definition</i> (US GAAP includes two) is included in the glossary sections of Topic 842. The second definition of probable is that ‘the future event or events are likely to occur’.
<b>Remote</b>	The chance of the future event or events occurring is slight.

This chapter addresses those concepts and definitions that are key to applying both the lessee and lessor accounting models. There are additional definitions and concepts that apply solely to lessees (see chapter 6) or solely to lessors (see chapter 7), as well as definitions and concepts that are key to identifying a lease (see chapter 3) and identifying lease/non-lease components (see chapter 4) that are discussed in the respective chapters.

## 5.1 Commencement date



### Excerpt from ASC 842-10

#### 55 Implementation Guidance and Illustrations

##### General

- > Implementation Guidance
- > Commencement Date

**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.

**55-21** Lease costs (or income) associated with building and ground leases incurred (earned) during and after a construction period are for the right to use the underlying asset during and after construction of a lessee asset. There is no distinction between the right to use an underlying asset during a construction period and the right to use that asset after the construction period. Therefore, lease costs (or income) associated with ground or building leases that are incurred (earned) during a construction period should be recognized by the lessee (or lessor) in accordance with the guidance in Subtopics 842-20 and 842-30, respectively. That guidance does not address whether a lessee that accounts for the sale or rental of real estate projects under Topic 970 should capitalize rental costs associated with ground and building leases.

- • > Master Lease Agreements

**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.

5.1.10 A lessee may take possession of or be given control over the use of an underlying asset – i.e. the underlying asset may be made available for use by the lessee – before: [842-10-55-19]

- the lessee begins operations – e.g. before the lessee begins selling from a leased retail space;
- lease payments are required to be made under the contract; or
- a stated commencement date in the contract.

5.1.15 The underlying asset has been made available for the lessee's use when it is available for constructing or installing a lessee asset (e.g. a lessee-owned leasehold improvement). Examples 5.1.10 and 5.1.15 illustrate the effect of lessee- versus lessor-owned leasehold improvements on the commencement date, while Questions 5.4.80 and 5.4.81 discuss determining the accounting owner of leasehold improvements. [842-10-55-19]



## Observation

### Properly identifying the commencement date is key

5.1.20 An improperly determined commencement date could result in one or more of the following. [ASU 2016-02.BC182–BC183]

- Misstated lease assets and lease liabilities – i.e. the recognition of lease assets and lease liabilities that do not yet exist or not recognizing lease assets and lease liabilities that do exist.
- Improper measurement of lease assets and lease liabilities – key inputs that are used in the initial and subsequent measurement of lease assets and lease liabilities (e.g. the lessee's incremental borrowing rate or the fair value of the underlying asset) change over time such that determining those inputs as of an incorrect date could result in the inaccurate measurement of lease assets and lease liabilities throughout the lease term.
- Lease cost or lease income (operating lease income or interest income on a sales-type or direct financing lease) that is recognized over the wrong lease period – i.e. begins to be recognized too early or too late.
- In the case of sales-type lessors (see section 7.3), selling profit or selling loss that is recognized in the wrong period.



## Example 5.1.10

### Lease commencement date – constructing leasehold improvements

Lessee LE signs a lease with Lessor LR for an identified space in a shopping mall on June 1, 20X1 – i.e. contract inception is June 1, 20X1.

#### **Scenario 1: Lessee owns leasehold improvements – Lessee constructs**

On August 1, 20X1, LR provides LE with access to the location so that LE can begin constructing leasehold improvements it will own (see Question 5.4.80) in anticipation of opening the store on September 1, 20X1. On September 1,

20X1, LE opens the store for business and pays LR the first month's lease payment.

In this example, the lease commencement date is August 1, 20X1. This is the date on which LR makes the underlying asset (i.e. retail space) available for use by LE. LE commencing operations and making lease payments beginning on September 1, 20X1 does not affect determination of the commencement date.

### **Scenario 2: Lessee owns leasehold improvements – Lessor constructs**

Assume the same facts as in Scenario 1, except that LR will construct the LE-owned leasehold improvements. LE personnel will not be able to freely access the store until the leasehold improvements are complete and a certificate of occupancy is obtained.

Consistent with Scenario 1, the lease commencement date is August 1, 20X1. It is not relevant to this conclusion that LR, rather than LE or a third party hired by LE, will construct the leasehold improvements, or that LE's personnel cannot freely access the building as of that date.

The lease commences on August 1, 20X1 because LE controls its use from that date. LE is both:

- obtaining substantially all of the economic benefits from use of the location – i.e. the space is being used exclusively for construction of LE's leasehold improvements; and
- directing the use of the location by deciding the leasehold improvements to be constructed therein.

### **Scenario 3: Lessor owns leasehold improvements**

On August 1, 20X1, LR provides LE with access to the location. LR has engaged LE as its construction agent to construct specific improvements that will permit the space to be used as a fast food restaurant (e.g. specific plumbing, electrical and other safety features), including beyond the end of LE's lease.

If LR and LE do not agree to extend the lease, LR will be able to re-lease the space to any number of other fast food restaurateurs. LR is considered the accounting owner of the improvements on the basis that, subject to the terms of the lease, LE cannot remove or alter those improvements without LR's consent and LR retains those improvements, which can serve future lessees, at the end of the lease.

The improvements are completed on September 30, 20X1, and consequently LE is permitted to occupy and commence operations on October 1, 20X1. Because LR is the accounting owner of the leasehold improvements, a lease of those improvements exists (as part of the single restaurant space lease component – see section 4.1) under Topic 842, even if the improvements are not explicitly identified in the contract as part of the underlying asset. LE has the right to use the improvements (along with the remainder of the inseparable restaurant space) throughout the lease term.

Because the specified improvements are part of the underlying asset owned by LR, the lease does not commence until the completed asset is made available for LE's use, which as per the preceding paragraph is October 1, 20X1.

Therefore, the lease commencement date for the single lease component (i.e. the restaurant space inclusive of the improvements) is October 1, 20X1.



### Example 5.1.15

#### **Lease commencement date – new construction**

On June 1, 20X1, Lessee LE signs a lease with Lessor LR for a new building to be constructed that will serve as LE's new headquarters. LR will construct the building, and is the legal and accounting owner of the building both during and after construction. LR's construction of the building is expected to be completed on June 1, 20X3.

As of April 1, 20X3, construction is mostly completed. LR grants LE access to the building for LE to begin installing leasehold improvements LE will own (see Question 5.4.80). LE's access to the building is restricted by LR's certificate of occupancy to construction personnel working on behalf of LE to install LE's leasehold improvements. As of April 1, 20X3, LE cannot begin using the building for its intended purpose (i.e. as its corporate headquarters).

On June 1, 20X3, building construction is completed. On July 1, 20X3, LE's leasehold improvements are completed and LE begins using the building as its headquarters.

The lease commencement date is April 1, 20X3. Once LE is given permission to access the building to begin installing its own leasehold improvements, LR has made the building available for LE's use and the lease has commenced.

It is not relevant that LE cannot begin to use the building for its intended purpose due to the ongoing LR construction and LE's restricted access rights. Lease commencement occurs, despite the restrictions, because LE's access permits it to install the leasehold improvements it needs for the building to be able to fulfill its role of a corporate headquarters. Without such access, LE would not be able to commence headquarters operations in the building by July 1, 20X3.



### Question 5.1.10

#### **Payments and costs associated with shipping, delivery, installation or similar activities that occur pre-commencement**

#### **How should a lessee and a lessor account for payments and costs associated with shipping, delivery, installation or other similar activities that occur before lease commencement?**

**Background:** Question 4.2.05 discusses that lessor activities to ship, deliver, install or undertake similar activities related to the underlying asset before lease commencement do not provide a service to the lessee; therefore, they are not a non-lease component of a contract that is or contains a lease. This is the case

regardless of whether the lessor performs the activities itself or engages a third party to undertake those activities.

**Interpretive response:** For lessees and lessors, contractual payments *to the lessor* for activities of the nature described in the background are either prepaid lease payments (if there are no non-lease components in the contract) or are prepayments of the ‘consideration in the contract’ (if there are lease and non-lease components of the contract).

### Lessee payments to a third party unrelated to the lessor

The lessee may pay a third party that is unrelated to the lessor to undertake these activities before lease commencement. These amounts are not lease prepayments (or prepayments of the ‘consideration in the contract’) because they are not payments to the lessor. Based on discussions with the FASB and SEC staffs, we believe:

- the costs incurred to the third party (or third parties) do not meet the definition of ‘initial direct costs’ as they are not incurred ‘because the lease contract was obtained’. Instead, the costs are incurred for the third party to provide a requested service – e.g. delivery or installation; and
- because the costs are not initial direct costs, there are two acceptable approaches to accounting for these costs by the lessee:
  - capitalize the costs by analogy to the guidance in Topic 360 (property, plant and equipment) because they are incurred to prepare the ROU asset for its intended use; or
  - expense the costs as incurred.

### Lessor costs to undertake activities

In addition to receiving payments from the lessee for undertaking activities of the nature described in the background, the lessor will typically incur costs to fulfill those activities (which may include payments to third parties to undertake the activities on the lessor’s behalf – e.g. to deliver the underlying asset to a lessee-designated location).

A lessor’s accounting for those costs depends on whether the lessor is a manufacturer or a dealer.

#### Lessor is a manufacturer or dealer

Based on discussions with the FASB and SEC staffs, these costs do not meet the definition of ‘initial direct costs’ because they are not incurred ‘because the lease contract was obtained’. Instead, these costs are incurred because the lessor undertakes the shipping, delivery, installation or other activities.

Because the costs are not initial direct costs, and based on discussions with the FASB and SEC staffs, we believe there are two acceptable approaches to accounting for these costs by the manufacturer or dealer lessor, provided the accounting for such costs is not addressed by another US GAAP Topic (e.g. Topic 360).

- **Capitalize or expense the fulfillment costs in accordance with Subtopic 340-40.** Apply the contract fulfillment costs guidance in Subtopic 340-40 by analogy. This means capitalize or expense the fulfillment costs as incurred based on whether such costs are eligible for

capitalization under that Subtopic. If capitalized, follow the amortization guidance for capitalized contract costs under that Subtopic, which requires the entity to amortize the costs consistent with the transfer to the customer of the goods or services to which the costs relate. Lessors following this accounting policy must apply all of Subtopic 340-40's requirements, including its impairment provisions. See chapter 12 of KPMG Handbook, [Revenue recognition](#), for further guidance on applying Subtopic 340-40.

- **Expense the fulfillment costs as incurred.** Expense the costs as incurred because Topic 842 does not include fulfillment costs guidance such as that in Subtopic 340-40.

#### ***Lessor is not a manufacturer or dealer***

The fair value of the underlying asset equals its cost, which reflects volume or trade discounts and includes the costs addressed by this question. An exception arises if there is a significant lapse in time between asset acquisition and lease commencement (see paragraph 7.3.41). [\[842-30-55-17A\]](#)

#### ***Sales-type and direct financing leases***

When there is *not* a significant time lapse between asset acquisition and lease commencement, the costs become part of the measurement of the lessor's net investment in the lease – which is initially measured at the fair value of the underlying asset plus any deferred initial direct costs, and net of any selling profit on the lease if a direct financing lease (see section 7.3.1).

The costs get included in the net investment in the lease and affect lease income in the same way as initial direct costs (see paragraph 7.3.35) even though they do not meet the definition of initial direct costs. They affect lease income by reducing the interest income earned by the lessor over the lease term – as compared to what the lessor would earn if the costs were not included in the measurement of the net investment in the lease.

If there is a significant time lapse between asset acquisition and lease commencement, the accounting described in paragraphs 7.3.43 – 7.3.45 will generally apply.

#### ***Operating leases***

Regardless of whether there is a significant time lapse between asset acquisition and lease commencement, if the lease is an operating lease (see Question 7.3.01), the costs form part of the cost basis of the underlying asset. For lessors that are not manufacturers or dealers, the underlying asset is generally depreciated so that its carrying amount equals its estimated residual value at the end of the lease term. [\[ASU 2019-01.BC10\]](#)



### Example 5.1.20

#### **Lease commencement date – mobilization of equipment**

##### **Scenario 1: Initial location predetermined in the lease**

Lessee LE signs a lease with Lessor LR for use of an offshore drilling rig on June 1, 20X1 – i.e. contract inception is June 1, 20X1. The lease requires LR to move the drilling rig to a predetermined location before LE is required to make any day-rate payments to LR. LE will, however, make a nonrefundable up-front ‘mobilization’ payment to LR before LR moves the rig to the predetermined location.

LR undertakes the mobilization on July 1, 20X1 and the drilling rig arrives at the designated location on August 1, 20X1 with the assigned LR crew. LE can begin to drill from August 1, 20X1 and is responsible for paying LR the applicable day-rate.

In this scenario, the lease commencement date is August 1, 20X1. This is the date on which LR makes the underlying asset (i.e. the rig) available for use by LE; from that date, LE can exercise its rights under the contract to direct the use of the drilling rig. Whether LE has plans to, or does, commence drilling operations on that date does not affect determination of the commencement date.

LE and LR account for the nonrefundable mobilization payment as a prepaid lease payment. Regarding its mobilization costs, LR can elect to either:

- apply the guidance in Subtopic 340-40 to the costs by analogy, capitalizing (and amortizing) or expensing them as appropriate under that guidance; or
- expense the mobilization costs as incurred.

##### **Scenario 2: Initial location designated by lessee**

Assume the same facts as Scenario 1, except that the lease does not require LR to move the drilling rig to a predetermined location and LE does not make an up-front mobilization payment. Instead, the contract provides that beginning on June 1, 20X1, LE has the right to instruct LR where and when to move the rig, and if it does so, it pays LR a specific rate for each day LR is moving the rig. LR undertakes mobilization of the rig after it receives instruction from LE and it arrives at the designated location on August 1, 20X1, at which point LE can begin drilling.

In this scenario, the lease commencement date is June 1, 20X1 because this is the date on which LR makes the underlying asset available for use by LE – i.e. LE controls how and for what purpose the asset is used by virtue of the fact that it can instruct LR where and when to move the rig from June 1, 20X1. This would be the case even if LE is not responsible for paying LR the applicable day-rate under the lease terms until LE actually begins drilling activities on August 1, 20X1.

Because lease commencement occurs before LR’s actions to move the rig to LE’s initial drilling location, in doing so LR’s actions fulfill its non-lease operation services. LE’s payment of the moving ‘day rate’ is accounted for by LE and LR in the same manner as LE’s other day-rate payments. LR expenses its non-

lease fulfillment costs to move the rig as incurred because they do not meet the criteria for fulfillment cost capitalization in Subtopic 340-40 – i.e. the costs do not generate or enhance resources of LR that will be used to satisfy a performance obligation *in the future*; the costs relate to LR's present performance of moving the rig to LE's designated location, satisfying LR's operation services performance obligation. See section 12.5 of KPMG Handbook, [Revenue recognition](#). [340-40-25-5(b), 25-8(c)]



## Comparison to legacy US GAAP

### Inception vs. commencement date

5.1.30 Under Topic 840, the initial measurement of a lease (e.g. determination of the discount rate for a capital lease) and the assessment of lease classification occurred at contract inception, rather than at the commencement date.

5.1.40 The recognition date for leases is consistent between Topic 840 and Topic 842 (commencement date). However, because inputs such as the fair value of the underlying asset and the lessee's incremental borrowing rate might be different between those two dates, entities might reach different conclusions about initial measurement and lease classification for some leases using the commencement date versus the inception date. [840-10-25-1]

## 5.2 Reasonably certain



### Excerpt from ASC 842-10

#### 55 Implementation Guidance and Illustrations

##### General

- > Implementation Guidance
- > Lease Term and Purchase Options
- • > Reasonably Certain

**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.

> Illustrations

- > 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.

• • > 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 ( $6.5\% \times \$248,834$ ) and amortization of the right-of-use asset of \$35,548 ( $\$248,834 \div 7$ ).

**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 ( $\$248,834 - [\$35,548 \times 5]$ ), 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.

• • > 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 ([ $\$65,000 \times 5$  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 ( $6.5\% \times \$335,808$ ) and amortization of the right-of-use asset of \$33,581 ( $\$335,808 \div 10$ ).

**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 ( $\$335,808 - \$33,581 \times 5$ ), 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.

5.2.10 The concept of 'reasonably certain' is integral to determining the 'lease term' (see section 5.3) and the 'lease payments' (see section 5.4).

5.2.20 Leases often include options that permit the lessee to extend or renew the lease (including by *not* exercising a termination option) or to purchase the underlying asset. Such options are accounted for (i.e. included in the measurement of lease assets and lease liabilities) only when it is 'reasonably certain' that the lessee will exercise the option. It is assumed that a lessee termination option will be exercised unless the lessee is reasonably certain *not* to do so. [842-10-30-1]

5.2.30 'Reasonably certain' is a high threshold of probability that must be met to include optional lessee payments in the measurement of lease assets and lease liabilities. When combined with the economic nature of the evaluation, the Board intended the parties to account for lessee options only when the lessee has a compelling *economic* reason to exercise the renewal or purchase option (or not to exercise a termination option). [IASU 2016-02.BC194, BC197, BC218]



### Observation

**'Reasonably certain' synonymous with 'reasonably assured'**

5.2.40 While Topic 842 uses the term 'reasonably certain', Topic 840 used the term 'reasonably assured' to describe the probability threshold that must be met for including lessee options in the measurement of lease assets and lease liabilities and in considering lease classification.

5.2.41 The Board views these terms as synonyms that should be applied in the same way. Therefore, the probability threshold for including lessee options in the measurement of lease assets and lease liabilities, and in considering lease classification, is the same as in Topic 840. The Board selected the term

'reasonably certain', rather than retaining the term 'reasonably assured', to converge with IFRS 16 terminology in this respect. [\[ASU 2016-02.BC195\]](#)

5.2.50 An entity assesses whether a lessee is reasonably certain to exercise or not to exercise an option by considering all economic factors relevant to that assessment: contract-based, asset-based, entity-based and market-based factors. An entity's assessment will often require the consideration of a combination of factors because they are interrelated. Therefore, an expectation of exercise alone (e.g. based on relevant history in similar arrangements or management's intent) does not result in a conclusion that the lessee is reasonably certain to exercise an option if there is not a compelling economic reason to do so. [\[842-10-55-26, ASU 2016-02.BC193\]](#)

5.2.60 All factors are considered together and the existence of any one factor does not necessarily indicate that a lessee is reasonably certain to exercise the option. Although not exhaustive, Topic 842 includes the following examples of factors to consider. [\[842-10-55-26\]](#)

Type of factor	Examples
<b>Contract-based</b>	<ul style="list-style-type: none"> <li>— Amount of the lease payments (including variable lease payments) in any optional period as compared to market rates</li> <li>— Existence and amount of any variable lease payments or other contingent payments</li> <li>— Existence and terms of options (renewal or purchase)</li> <li>— Costs associated with an obligation to return the leased asset in a specified condition or to a specified location</li> </ul>
<b>Asset-based</b>	<ul style="list-style-type: none"> <li>— Location of the asset</li> <li>— Existence of significant leasehold improvements that would be lost if the lease were terminated or not extended</li> <li>— Noncontractual relocation costs</li> <li>— Costs associated with lost production</li> <li>— Costs associated with sourcing an alternative item</li> </ul>
<b>Entity-based</b>	<ul style="list-style-type: none"> <li>— Financial consequences of a decision to extend or terminate a lease</li> <li>— Nature of the leased asset (specialized versus non-specialized; the extent to which the asset is crucial to the lessee's operations, etc.)</li> <li>— Tax consequences of terminating or not extending the lease</li> </ul>
<b>Market-based</b>	<ul style="list-style-type: none"> <li>— Statutory law and local regulations</li> <li>— Market rentals for a comparable asset</li> </ul>



### Question 5.2.10

#### Facts and circumstances and additional factors to consider

##### Can an entity reach different conclusions about whether exercise is reasonably certain for two options with very similar terms that relate to different leases?

**Interpretive response:** Yes. The particular facts and circumstances of a lease can significantly affect an entity's assessment of a lessee option such that an entity might reach different conclusions about whether exercise is reasonably certain for two options with seemingly very similar terms (e.g. the same strike price and the same expected fair value of the underlying asset) based on different underlying facts and circumstances.

The following are examples.

- The further out into the future the option exercise date, the more compelling the evidence must be, on an economic basis, that the lessee will exercise the option. This is because an entity's estimates about conditions that will exist at the option date will be less precise the further out the option date is; these estimates include, but are not limited to, the fair value of the underlying asset, the availability of suitable alternatives to the underlying asset and the tax environment in a particular jurisdiction.
- The nature of the underlying asset may significantly affect an entity's assessment of a lessee option. Depending on the nature of the underlying asset, it may be more difficult for an entity to predict its fair value or the availability of suitable alternative resources. This is illustrated in Example 5.2.10.
- The location of the underlying asset could significantly affect relocation costs or the availability of alternative resources. For example, even for two identical underlying assets, considerations about relocation costs or available alternative resources could vary widely if one is deployed in a remote area and the other in a readily accessible area.
- The jurisdiction governing the lease could significantly affect the assumptions about laws and regulations (including tax consequences) affecting the assessment of the option; for example, laws and regulations in some countries may be more stable and predictable than in other countries.



### Question 5.2.20

#### Lessees and lessors may reach different conclusions

**Can lessors and lessees reach different conclusions about whether it is reasonably certain that an option will be exercised?**

**Interpretive response:** Yes. The nature of the assessment of 'reasonably certain', which is based on judgments (e.g. about the importance of an identified asset to the lessee) and estimates (e.g. of the fair value of the asset in the future) means that lessees and lessors may reach different conclusions about whether it is reasonably certain that a lessee will exercise a renewal or purchase option, or not exercise a termination option.



### Example 5.2.10

#### Assessment of a lessee renewal option

##### Scenario 1: Not reasonably certain to exercise either of the renewal options

Lessee LE enters into a five-year warehouse lease with Lessor LR.

As part of the contract, LE has the option to renew the five-year lease for two additional five-year terms (i.e. for 15 years in total) at the market price at the date of exercising each renewal option. If LE does not renew the lease, it is responsible for its costs to vacate the facility, relocate to a new facility and return the warehouse to its pre-lease condition.

LE has a track record of remaining in leased warehouse facilities for at least 10 years. It was in each of its previous three facilities for 15, 10 and 15 years, respectively.

In this scenario, both LE and LR conclude that LE is not reasonably certain to exercise either of the five-year renewal options for the warehouse facility.

LE's history of renewing its warehouse leases may suggest that there is an intent on the part of LE to exercise at least the first of the two five-year renewal options. However, the fact pattern does not suggest that LE is reasonably certain to do so.

The fact that LE will have to incur costs (e.g. relocation, restoration, etc.) if it does not renew the lease also does not make it reasonably certain that LE will renew the lease to avoid those costs. This is because LE will likely incur those costs at some point given the terms of the lease and it is also not reasonably certain that LE will not, five years into the future, offset those costs through favorable lease terms for a replacement facility or other economic factors relevant to the new lease.

### Scenario 2: Significant leasehold improvements

Changing the facts of Scenario 1, before moving into the leased facility, LE constructs expensive leasehold improvements with an economic life of 15 years.

These leasehold improvements will have significant economic value to LE at the end of both five and 10 years that it will not be able to recover if it vacates the facility. LE will have to remove the improvements and they are not portable to another location.

The construction of the significant leasehold improvements and the economic factors surrounding those improvements (e.g. that a significant portion of their substantial economic value will be lost if LE relocates before the end of 15 years) provides a compelling economic reason for LE to remain in the facility for the full 15 years permitted.

Therefore, in this scenario, both LE and LR conclude that it is reasonably certain that LE will exercise both of its five-year renewal options.

### Scenario 3: Specialized facility

Again changing the facts of Scenario 1, the warehouse is a highly specialized facility. There are only a limited number of facilities of this nature, no two of which (presently or historically) are in the same geographic area. Constructing a facility of this nature is expensive and requires significant time. Having access to a specialized facility of this nature and in this geographic area is vital to LE's core operations.

Between now and the end of the non-cancellable period of the lease (i.e. five years), it is highly unlikely that LR or another entity will construct a suitable alternative facility in the same geographic area as the warehouse being leased. The investment of time and resources that would be required, together with the fact that doing so would invite one of LE's competitors to operate in the area (i.e. by leasing the specialized warehouse from LR), creates a significant economic disincentive for LE to construct its own specialized facility. Therefore, in this scenario, both LE and LR conclude that it is reasonably certain, based on an evaluation of the relevant economic factors, that LE will exercise the first five-year renewal option.

However, both LE and LR conclude that it is *not* reasonably certain, at lease commencement, that LE will exercise the second five-year renewal option. While the same economic circumstances considered in determining that LE is reasonably certain to exercise the first five-year renewal option *might* exist 10 years from now, reasonably certain is a high threshold of probability. The extended period of time between lease commencement and the exercise date for that option (i.e. approximately 10 years) means that it is not *reasonably certain* that those same economic circumstances will exist.



### Example 5.2.20

#### **Assessment of a lessee purchase option with strike price below expected fair value**

##### **Scenario 1: Fair values volatile**

Lessee LE enters into a five-year lease with Lessor LR to use a piece of equipment in an evolving area of the technology sector; there are no renewal or termination options. LE has the option under the contract to purchase the underlying asset at the end of the non-cancellable lease term for \$500,000. The expected fair value of the asset at the end of the non-cancellable lease term is \$650,000.

Both LE and LR conclude that it is *not* reasonably certain that LE will exercise the option. The underlying asset is in an evolving area of the technology sector, and the duration of the non-cancellable period of five years (between the assessment of the option at lease commencement and the option exercise date) is significant in that context. Therefore, each party concludes that there is too much uncertainty about what the fair value of the underlying asset will be at the option exercise date to conclude at lease commencement that LE is reasonably certain to exercise the option; for example, newer, better alternative assets may be introduced during the five-year lease term.

In this scenario, the lease term (five years) and specific environment (technology sector) are important factors in reaching the conclusion. A shorter lease term (e.g. one or two years) or a different environment might lead to a different conclusion.

##### **Scenario 2: Fair values historically stable**

Changing the facts of Scenario 1, the underlying asset is conventional real estate (e.g. a building that could be used for a variety of purposes) in a market that historically has been highly predictable to within a narrow range – prices have been predictable to within +/- 10 percent over a long period of time.

In this scenario, given the extent of the discount between the strike price (\$500,000) and the reasonably predictable expected fair value of the underlying asset (\$650,000), each of the parties concludes that it is reasonably certain that LE will exercise the purchase option.

As with Scenario 1, changes to this fact pattern could influence the conclusion reached. For example, if the strike price of the option were \$600,000 instead of \$500,000, it might not be reasonably certain that LE would exercise the option.

At that strike price, either (1) the \$50,000 forecasted discount may not be significant enough to conclude that LE is reasonably certain to exercise the option, or (2) there may be uncertainty, even within the historically predictable real estate market in the example, about whether the strike price will in fact represent a discount from the actual fair value of the building at the option exercise date.

## 5.3 Lease term



### Excerpt from ASC 842-10

#### 30 Initial Measurement

##### General

> Lease Term and Purchase Options

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.

**30-1** An entity shall determine the **lease term** as the noncancelable period of the **lease**, together with all of the following:

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

**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.

**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.

**30-4** See paragraphs 842-10-55-19 through 55-21 for implementation guidance on commencement date and paragraphs 842-10-55-23 through 55-27 for implementation guidance on lease term and purchase options. See Examples 23 through 24 (paragraphs 842-10-55-210 through 55-224) for illustrations of the requirements on purchase options.

#### 55 Implementation Guidance and Illustrations

##### General

> Implementation Guidance

- > Lease Term and Purchase Options

**55-23** An entity should determine the noncancelable period of a **lease** when determining the **lease term**. When assessing the length of the noncancelable 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**.

**55-24** If only a lessee has the right to terminate a lease, that right is considered to be an option to terminate the lease available to the lessee that an entity considers when determining the lease term, as described in paragraph 842-10-30-1(b). If only a lessor has the right to terminate a lease, the lease term includes the period covered by the option to terminate the lease, as described in paragraph 842-10-30-1(c).

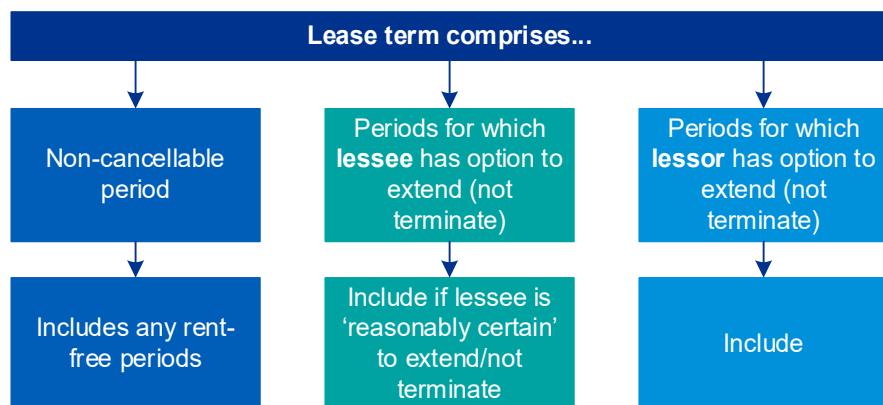
**55-25** The lease term begins at the **commencement date** and includes any rent-free periods provided to the lessee by the lessor.

• • > Fiscal Funding Clauses

**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.

5.3.10 Beginning at the commencement date, the lease term always includes the non-cancellable period and may include one or more optional periods.

[842-10-30-1, 55-25]



5.3.20 After the commencement date, a *lessee* may reassess the lease term upon the occurrence of certain events or changes in circumstances (see section 6.6) or in the case of a lease modification that is not accounted for as a separate contract (see section 6.7). Conversely, a *lessor* only reassesses the lease term in the event of a lease modification that is not accounted for as a separate contract (see section 7.6).

5.3.30 The lease term may be affected by the term of a sublease entered into by the lessee. Section 8.1 outlines the effects of entering into the sublease on the assessment of the lease term for the head lease by both the lessee and the lessor, specifically highlighting that entering into the sublease triggers a reassessment of the head lease term for the lessee, but not the lessor.



### Example 5.3.10

#### Initial lease term (lessee renewal options)

Assume the same facts as in Scenarios 1, 2 and 3 in Example 5.2.10. That example illustrates whether Lessee LE is, or is not, reasonably certain to exercise one or both renewal options provided. This example concludes on the 'lease term' for each of those scenarios based on the conclusions in Example 5.2.10.

For each of the scenarios in Example 5.2.10, the lease term equals the non-cancellable period of five years *plus* the periods covered by renewal options that LE is reasonably certain to exercise. That results in lease terms for each scenario as follows.

Example 5.2.10 Scenario	Lease term
Scenario 1	5 years
Scenario 2	15 years
Scenario 3	10 years

5.3.40 A contract is an agreement between two or more parties that creates enforceable rights and obligations. When assessing the non-cancellable period of a lease, an entity applies that definition to determine the period for which a contract exists. A lease is no longer enforceable, and therefore the lease term does not extend, beyond the point that both the lessee and the lessor have the unilateral right to terminate the lease, without permission from the other party and with no more than an insignificant 'penalty' (see paragraphs 5.3.80 – 5.3.90). [\[842 Glossary, 842-10-55-23\]](#)

5.3.50 If only a *lessee* has the right to terminate a lease, that right is considered to be an option to terminate the lease available to the lessee that an entity considers in determining the lease term. [\[842-10-55-24\]](#)

5.3.60 If only a *lessor* has the right to terminate a lease or controls the lessee's ability to exercise an option to terminate the lease, the lease term should assume that the lease will not be terminated. [\[842-10-55-24\]](#)

5.3.70 The lease term excludes periods after which both parties' unilateral termination rights (with no more than an insignificant penalty) are exercisable because neither party has enforceable rights or obligations.

- The lessee neither has the right to continue to use the underlying asset (after the lessor's termination rights become exercisable), nor an obligation to make lease payments (after its termination rights become exercisable).
- The lessor neither has a right to receive lease payments (after the lessee's termination rights become exercisable), nor an obligation to extend the lessee's right to use the underlying asset (after its termination rights become exercisable). This principle is illustrated in Example 5.3.20.



### Question 5.3.10

#### Legal evaluation of the non-cancellable period

##### What determines the 'non-cancellable period' of a lease?

**Interpretive response:** Whether and for what period a contract creates enforceable rights and obligations on the parties depends on the relevant laws and enforcement practices in the governing jurisdiction to which the contract is subject.

However, as a practical matter, in most cases a contract is no longer enforceable after it can be cancelled by either party, assuming that the cancellation/termination option is substantive because the entity can exercise that option without incurring a more-than-insignificant penalty.

- Once the lessee has the right to cancel the lease, the lessee no longer has an enforceable obligation to make the lease payments and the lessor no longer has an enforceable right to receive lease payments.
- Similarly, once the lessor has the right to cancel the lease, the lessee no longer has an enforceable right to use the underlying asset and the lessor no longer has an enforceable obligation to permit the lessee use of the underlying asset.

5.3.80 While 'penalty' is a defined term in Topic 842, it has a broad meaning. It encompasses economic penalties beyond any requirement for the terminating party to make a cash payment to the other party. Lessees and lessors need to consider the broad definition of a penalty when assessing whether both the lessee and the lessor have the right to terminate the lease with no more than an insignificant penalty. Incorrect conclusions on this point can result in:

[842 Glossary]

- inaccurate measurement of lease assets and liabilities;
- incorrect lease classification; and/or
- for lessees, incorrect conclusions about eligibility for the short-term lease exemption.

5.3.90 A penalty may expire or, over a period of time, the effect of a penalty that is initially more than insignificant may become insignificant. For example, a termination penalty that is more than insignificant if exercised after only one year of a lease may be insignificant after two or three years when considered in the context of the entire arrangement.

5.3.100 Under a fiscal funding clause, a lease is cancellable if the legislature or other funding authority does not appropriate the funds necessary for the governmental unit (as lessee) to fulfill its obligations under the lease agreement. The existence of such a clause requires an assessment of the likelihood of lease cancellation through exercise of the fiscal funding clause. If it is more than remote that the fiscal funding clause will be exercised, the lease term should include only those periods for which funding is reasonably certain. [842 Glossary, 842-10-55-27]



### Question 5.3.20

#### **Effect of termination notice clauses on the non-cancellable period**

**Does a clause in a lease that requires a termination notice before a lessee or lessor can formally terminate a lease contract affect the non-cancellable period of a lease?**

**Interpretive response:** Yes. When either the lessee or lessor has the right to terminate a lease at any time on giving notice to the other party, the non-cancellable period of the lease includes the 'notice' period.

For example, a lease agreement may grant each party the unilateral right to terminate the lease, for any reason and without penalty (see paragraphs 5.3.80 – 90), on giving 90 days' notice to the other party. This means that at any point in time before such notice is given by either party, enforceable rights and obligations for both parties exist for 90 days. Therefore, at lease commencement, and until either party gives notice of its intent to terminate the lease, the non-cancellable period of the lease is 90 days.



### Question 5.3.25

#### **Contingent termination provisions**

**Does a contingent termination provision in a lease affect the non-cancellable period of a lease?**

**Background:** A lessee may have the right to terminate the lease before the end of the stated non-cancellable period in the contract only if a future event occurs or circumstance arises. For example, despite a stated non-cancellable lease period of 10 years, the lessee may have the contingent right to terminate the lease on or after an earlier date if a designated event occurs (or does not occur) or condition exists.

For example, a lessee has the right to terminate a retail space lease with a 10-year stated non-cancellable term after 5 years of that term if its average annual sales from the retail space over that 5-year period are less than a specified amount. This provision gives the lessee the ability to early terminate a lease that is not providing its desired return.

**Interpretive response:** Yes. Considering the retail space example in the background, even though the lease contract has a *stated* non-cancellable lease period of 10 years, we believe the non-cancellable period of the lease is only 5 years because of the contingent termination provision.

We believe an entity (lessee or lessor) assesses a contingent termination provision the same way it assesses a non-contingent termination provision. That is, the entity includes the period(s) after the contingent termination option in the 'lease term' only if the lessee is reasonably certain *not* to exercise the option.

When assessing whether the lessee is reasonably certain not to exercise the contingent termination option, we believe an entity considers both of the following.

- **The probability of the contingency occurring or arising.** If it is remote that the contingent event will occur or circumstance arise, the lessee is reasonably certain not to terminate the lease because the contingent termination option will not be exercisable.
- **The likelihood the lessee will choose not to terminate the lease even if the contingency is triggered.** If the contingency is at least more than remote (i.e. reasonably possible) of being triggered, an entity further considers other relevant economic factors (see paragraph 5.2.60) that could suggest the lessee would not exercise the option.

There may be other economic factors that would induce the lessee not to terminate the lease even if the contingency is triggered. For example, the retailer described in the background may incur significant costs to relocate its store or forfeit valuable leasehold improvements, or there may be limited other viable store location options. As a result, the retailer's average annual sales would have to be *significantly* below the triggering amount before it would vacate the leased property, and it may be remote that the retailer would fail to hit this *even lower* performance target.

The following table summarizes our view on analyzing a contingent termination provision.

Likelihood of contingency occurring or arising	Other economic factors considered?	Reasonably certain conclusion
<b>Remote<sup>1</sup></b>	N/A. It is reasonably certain the termination option will not become exercisable, so no other economic factors need be considered.	Lessee is <b>reasonably certain to not terminate.</b>
<b>More than remote</b>	Yes. Consider likelihood of termination option exercise based on the same factors that would be considered if the termination option were <i>not</i> contingent (see paragraph 5.2.60).	<b>It depends. Consider likelihood of triggering the option together with other relevant economic factors.</b>

Note:

1. Remote is 'the chance of the future event or events occurring is slight'. [\[842 Glossary\]](#)



### Question 5.3.30

#### **Extension or renewal options controlled by an unrelated third party**

**Does the lease term automatically include extension or renewal options controlled by a third party unrelated to either the lessee or the lessor?**

**Interpretive response:** No. Only extension or renewal options controlled by the lessor are automatically included in the lease term. [842-10-30-1(c)]

Based on discussions with the FASB staff, we believe options controlled by another unrelated third party (e.g. a sublessee) are subject to the same reasonably certain assessment as lessee-controlled options. Unless the third party is reasonably certain to exercise, or force the exercise of, the extension or renewal option (or not to terminate the lease at an available termination date), it is not included in the lease term.

We understand that the FASB staff believes that paragraph 842-10-30-1(c) establishes a rule; it does not provide a principle that should be extrapolated to other situations in which exercise of an option is outside of the control of the lessee.



### Question 5.3.40

#### **Lease term when lessee and lessor both have termination rights – lessor only incurs penalty**

**What is the lease term when both the lessee and lessor have termination rights – the lessor's right gives rise to a more-than-insignificant penalty while the lessee's does not?**

**Interpretive response:** When the lessor's termination right becomes exercisable at the same time as or after the lessee's termination option, the lease term is the shorter of the period from lease commencement until:

- a. the lessor's exercise of its termination option no longer gives rise to a more-than-insignificant penalty; or
- b. the lessee's termination option becomes exercisable plus any periods after that for which the lessee is reasonably certain not to exercise the option.

In contrast, if the lessor's termination right will no longer result in a more-than-insignificant penalty before the lessee's termination option becomes exercisable, the lessor-only termination option is disregarded for accounting purposes until the lessee's termination option becomes exercisable. When the lessee's termination option becomes exercisable, both the lessee and the lessor have the unilateral right to terminate the lease with no more than an insignificant penalty, and the lease term does not extend beyond that point (see paragraph 5.3.40). [842-10-30-1(c)]

Given the similarity between (1) what constitutes a penalty and (2) the factors in Topic 842 that could create a compelling economic reason for a lessee to renew (or not terminate) a lease, we generally would not expect (b) above to include periods after the lessee's termination option becomes exercisable. That is, we believe the absence of a more-than-insignificant penalty would generally mean the lessee is not reasonably certain to extend the lease beyond the date its termination option (that does not result in a more-than-insignificant penalty) becomes exercisable. [842 Glossary, 842-10-55-26]



### Question 5.3.50

#### **Lease term when lessee and lessor both have termination rights – lessee only incurs penalty**

**What is the lease term when both the lessee and lessor have termination rights – the lessee's termination right gives rise to a more-than-insignificant penalty while the lessor's does not?**

**Interpretive response:** When the lessee's termination right results in a more-than-insignificant penalty, regardless of when the lessor's termination right becomes exercisable, the lease term is the shorter of the period from lease commencement until:

- a. the lessee's exercise of its termination option no longer gives rise to a more-than-insignificant penalty; or
- b. the lessee's termination option becomes exercisable (without regard to the penalty) *plus* any periods after that for which the lessee is reasonably certain not to exercise its termination option.

'Reasonably certain' is a high threshold of probability. It is intended to capture situations in which the lessee is effectively compelled economically (has little or no choice but) to exercise an option. [ASU 2016-02.BC197]

Because of this and the similarity between (1) what constitutes a 'penalty' and (2) the factors in Topic 842 that could create a compelling economic reason for a lessee to renew (or not terminate) a lease, we would generally not expect an entity to conclude both that: [842 Glossary, 842-10-55-26]

- the lessee is reasonably certain to extend (i.e. not terminate) the lease; and
- terminating the lease will result in no or only an insignificant penalty.

In other words, we believe it will generally be the case that (b) is equal to or shorter than (a), and therefore it will generally not be necessary for an entity to calculate both (a) and (b).



## Example 5.3.20

### Termination rights

**Scenario 1: Lessee and lessor both have right to terminate – lessee's termination right gives rise to a more-than-insignificant penalty; lessor's does not**

Lessee LE and Lessor LR enter into a lease, granting LE the right to use LR's equipment for a non-cancellable period of one year. After one year, the lease will continue for up to four additional years (five years in total) unless cancelled by either party. The lease payments are fixed, and those payments are considered to be at-market at lease commencement.

Each party has the unilateral right to terminate the contract at the end of Years 1–4 by providing notice to the other party at least 30 days before the end of the then-current year. If LE terminates the contract, LE must pay to transport the equipment back to LR's location.

In addition, the following facts are relevant.

- Equivalent pieces of equipment are readily available for lease from other suppliers at a similar rental price and subject to similar contractual terms and conditions.
- The equipment must be installed before use. Installation costs are incurred each time a new piece of equipment is installed and the installation is a significant undertaking.
- The transportation costs that LE will incur to return the equipment to LR are substantial due to the location of LE's operations and the nature of the equipment.
- LE's operations depend on using this type of equipment.
- LE's operations will necessarily halt for a period of at least a few days if it needs or chooses to switch equipment units. The shut-down will result in lost production revenue and idle time costs related to LE's operating crew. The lost production revenue and idle costs that would result from a shut-down (collectively, 'shut-down costs') are substantial.
- The total of the expected additional installation, transportation and shut-down costs would be significant when compared to the annual lease payment.

Though LE and LR each have the unilateral right to terminate the lease at the end of Year 1, LE cannot do so without incurring a penalty. Based on the definition of 'penalty', if it chooses to terminate the lease, LE will incur a penalty comprising:

- additional installation costs LE will incur to install replacement equipment – i.e. LE needs equipment of this nature for its operations; therefore, additional installation costs constitute an 'economic detriment' to LE that would not be incurred if LE simply continued its lease with LR;
- transportation costs LE will incur to ship LR's equipment back to LR's location; and

- shut-down costs incurred while the equipment is being uninstalled and replaced – i.e. LE could avoid the shut-down costs by continuing its lease with LR.

Based on the expected significance of the penalty that would result, LE does not have the right to terminate the lease without a more-than-insignificant penalty at the end of Year 1. Therefore, only LR has an option to terminate the lease at the end of Year 1 without a more-than-insignificant penalty, while LE has no similar option until *at least* the end of Year 2.

Consequently, the lease term is the shorter of the period from lease commencement until:

- a. LE's exercise of its termination option no longer gives rise to a more-than-insignificant penalty; or
- b. LE's termination option becomes exercisable (without regard to the penalty) *plus* any periods after that for which LE is reasonably certain not to exercise its termination option.

With respect to (a), we know that period is *at least* two years. Similarly, the significance of the penalty and the short one-year period until the termination option becomes exercisable (without regard to penalty) mean LE is reasonably certain not to terminate the lease until *at least* the end of Year 2.

Additional facts that are not provided would be needed to determine the actual lease term (i.e. whether the lease term is two years or a longer period). These include the expected amount of the installation, transportation and shut-down costs; the annual lease payment amount; and expectations about the productivity of the equipment in the future – e.g. expectations about whether the equipment will decline in productivity and/or incur significant operational down-time as it ages, or that technological developments will reduce the desirability of the equipment to LE.

### **Scenario 2: Lessee and lessor both have right to terminate with no more than an insignificant penalty**

Assume the same facts as Scenario 1, except that:

- the equipment does not require significant installation efforts;
- transportation costs to return the equipment to LR are minor; and
- because there is no significant installation process, idle time incurred in switching the units is short.

Therefore, unlike in Scenario 1, LE's termination option at the end of Year 1 does not give rise to a more-than-insignificant penalty, and the non-cancellable period of the lease and the lease term are both one year.

LE has no:

- right to extend the lease beyond the end of Year 1 because LR has the right to terminate the lease at the end of Year 1 without a more-than-insignificant penalty; or
- obligation to make lease payments beyond the end of Year 1 because it can terminate the lease without incurring a more-than-insignificant penalty.

LR has no:

- right to receive lease payments (i.e. by requiring LE to extend the lease) beyond the end of Year 1 because LE has the right to terminate the lease at the end of Year 1 without a more-than-insignificant penalty; or
- obligation to extend LE's right to use the underlying asset beyond the end of Year 1 because it can terminate the lease without incurring a more-than-insignificant penalty.

### **Scenario 3: Only lessor has right to terminate**

Unlike in Scenarios 1 and 2, only LR has the right to terminate the lease at the end of Years 1–4. Because only LR can elect to terminate the lease and the lease term always includes optional periods controlled by the lessor, the lease term is five years. Whether LR's option can be exercised without LR incurring a more-than-insignificant penalty is not relevant in this scenario.



### Example 5.3.25

#### **Lessee partial termination right (downsizing clause)**

Lessee LE enters into a contract with Lessor LR to lease 1,000 mobile devices. Each device can be used and operated independently of the others. The stated lease term for each device is three years. There are no options to renew the lease after the three-year stated term.

#### **Scenario 1: All 1,000 leases can be terminated after 9 months**

LE can return all of the devices, at no cost, any time after 9 months.

In this scenario, all 1,000 leases have a 9-month non-cancellable period. If LE is not reasonably certain to continue the leases beyond the non-cancellable period, all 1,000 leases have a lease term of 9 months and for LE are 'short-term leases', eligible for the short-term lease exemption if LE has elected it (see section 6.3.1).

#### **Scenario 2: Only 400 leases can be terminated after 9 months**

LE can return a maximum of 400 devices, at no cost, any time after 9 months. (i.e. a 'downsizing clause'). LE must continue to lease the other 600 devices for the full, stated three-year term.

LE and LR account for the 1,000 leases as two separate populations.

- For 400 of the leases, LE and LR will assess whether LE is reasonably certain to continue the lease beyond the non-cancellable 9-month period. If LE is *not* reasonably certain to continue the leases beyond the non-cancellable period, all 400 leases have a lease term of 9 months and for LE are 'short-term leases', eligible for the short-term lease exemption if LE has elected it (see section 6.3.1).
- For 600 of the leases, the non-cancellable period of the lease is 3 years. Because there are no renewal or extension options beyond the 3 years, the lease term is also 3 years.

If LE has elected the short-term lease exemption and the 400 leases meet the definition of short-term leases, at lease commencement LE will only recognize lease liabilities and ROU assets for the 600 leases that have a lease term of three years.

**Note:** It would *not* be appropriate for LE to account for all 1,000 leases as short-term leases in this scenario even though the contract may permit LE to unilaterally select which 400 (of the 1,000) devices it will return after only nine months. This is because LE is obligated to lease at least 600 of the devices for three years.

#### **Alternative approach (LR only)**

LR considers that LE can return any 400 of the 1,000 devices. Therefore, at lease commencement, LE is not reasonably certain to continue the lease of any single device beyond 9 months. Consequently, LR accounts for all 1,000 leases as having a lease term of 9 months.

Unlike LR, LE controls which, if any, devices it returns under the downsizing clause. At any point it can select which devices it will and will not return. Therefore, it is not appropriate for LE to account for the arrangement as if it can return all 1,000 devices.



#### Question 5.3.60

#### **Lessee and lessor extend the lease even though both have the right to terminate without penalty**

#### **How should an entity account for a lease extension triggered by both parties *not* exercising their unilateral termination rights?**

**Background:** Consider Scenario 2 in Example 5.3.20. Both Lessee LE and Lessor LR have the right to terminate the lease at the end of Year 1. For both parties, the lease term is one year and a contract does not exist because neither party has enforceable rights or obligations beyond Year 1.

The question arises as to how LE and LR should account for the lease when neither party exercises their termination right at the end of Year 1, and therefore the lease continues into Year 2.

**Interpretive response:** We believe a modification occurs if neither party exercises its termination right, creating new enforceable rights and obligations that now exist until the next date at which both parties can terminate the lease without incurring a more-than-insignificant penalty – e.g. the end of Year 2 in Example 5.3.20, Scenario 2.

The contract modification in this scenario is a lease term extension, no different from the two parties having a non-cancellable one-year lease and executing an amendment to that lease extending the non-cancellable period by an additional year. The fact that the new enforceable rights and obligations that exist in Year 2 are created by both parties' *inaction* – i.e. *not* exercising their respective termination options – rather than by the parties executing a contract amendment is not relevant.

Both the lessee and the lessor will account for the lease term extension modification in the same manner as they would any other lease term extension modification. The accounting for lease modifications is discussed in sections 6.7 (lessees) and 7.6 (lessors). Examples 6.7.20 (lessee) and 7.6.10 (lessor) illustrate the accounting for a lease term extension modification.



### Example 5.3.30

#### No stated term

Lessor LR agrees to lease equipment to Lessee LE. There is no stated duration for the lease in the contract; however, the contract stipulates that LE is required to return the underlying asset to LR's location when it no longer wishes to use the equipment. For each day that the asset remains in LE's possession, LE will pay a fixed fee to LR for the right to use that asset.

The non-cancellable period of the lease is one day, because LE could elect to return the asset to LR's location before the start of Day 2.

Next, LE and LR each consider whether LE is reasonably certain to continue to use the asset beyond the non-cancellable period. Unless LE is reasonably certain to continue the lease beyond the first day, the lease term is only one day.

We believe the extremely short non-cancellable period of the lease (one day) will likely influence the determination of whether LE is reasonably certain to renew the lease beyond the non-cancellable period. The costs to LE of terminating the lease (e.g. returning the underlying asset to LR's location) and entering into a new lease (e.g. identifying another asset, entering into a different contract and training employees to use a different asset) may provide a compelling economic reason for LE to continue to use the same asset for a period that is longer than the non-cancellable period.



### Observation

#### Determining the lease term for cancellable ('evergreen') leases may be difficult

5.3.110 In defining a 'short-term lease', the Board considered that many evergreen leases (i.e. those on a day-to-day, week-to-week or month-to-month basis) would meet that definition. However, to qualify for the short-term lease exemption (see section 6.3.1) and to determine whether the disclosure requirement for short-term lease costs is applicable (the disclosure requirement applies only to short-term leases with a term greater than one month – see section 12.2), lessees must nonetheless assess the lease term for such leases. [IASU 2016-02.BC379]

5.3.120 The lease term for evergreen leases is established in the same manner as for all other leases, which means considering whether the lessee is reasonably certain to exercise one or more available renewal options.

5.3.130 As highlighted by Example 5.3.30, determining whether a lessee is reasonably certain to exercise a renewal option in an evergreen lease may involve significant judgment. We believe that, in general, the shorter the non-cancellable period of a lease, the greater the likelihood that the lessee is reasonably certain to exercise one or more lease term renewal options. This is because, in many cases, it may be cost prohibitive to continually substitute leased assets. For example, if a lessee is leasing a piece of construction equipment on a weekly basis and expects to need a substantially similar piece of equipment for the duration of a four-month project, there may be a compelling economic reason not to continually substitute that asset throughout the period.



### Question 5.3.70

#### Terminal rental adjustment clauses (TRAC leases)

**Does the presence of a terminal rental adjustment clause make it reasonably certain that a lessee will exercise an option to renew (or not terminate) the lease?**

**Background:** A terminal rental adjustment clause (or TRAC) is a clause in a motor vehicle lease contract that provides for a final rental payment adjustment at the end of the lease, typically based on the amount realized by the lessor from sale of the vehicle. In a common example, at the end of the lease, the lessor sells the vehicle and any difference between the sales price and the depreciated book value of the vehicle is either:

- owed by the lessor to the lessee – i.e. if the sales price is more than the depreciated book value; or
- owed by the lessee to the lessor – i.e. if the sales price is less than the depreciated book value.

The specifics of a TRAC can vary by contract. For example, whether the lessee or the lessor has to pay 100% of the difference between sales price and depreciated book value, and the depreciation method used to calculate the depreciated book value, is often a matter of negotiation between the lessee and the lessor.

In a TRAC lease, the lessee typically has a number of renewal options and the TRAC adjustment will usually vary depending on when the lessee ultimately terminates the lease.

**Interpretive response:** It depends on the facts and circumstances. It is particularly important to understand how the TRAC is structured.

At the renewal/extension date being evaluated (i.e. when evaluating whether the lessee is reasonably certain to exercise a particular renewal option), there may be a reasonable possibility that the final rental payment adjustment could be either a payment to the lessee or a payment to the lessor. In that case, we do not believe the TRAC would *in isolation* drive a conclusion that the lessee is reasonably certain to exercise a renewal option to avoid a possible TRAC payment.

Similarly, a TRAC payment by the lessee may be expected (i.e. it is remote that the TRAC adjustment will be a payment *to the lessee* or that no payment will be made to either party), but it is reasonably possible that the amount of the adjustment will not be significant in the context of the lease (see next paragraph). Under these circumstances, again, we do not believe the TRAC would *in isolation* result in a conclusion that the lessee is reasonably certain to exercise a renewal option. This is because 'reasonably certain' is a high threshold of probability that must be met (see section 5.2).

In assessing the significance of the TRAC adjustment, it should be considered in the context of the lease to which it applies. It should *not* be evaluated, for example, based on whether it would be material to the lessee.

Therefore, if there is a reasonable possibility that the TRAC payment adjustment will be either (1) in the lessee's favor or (2) insignificant, then generally it will not be reasonably certain that the lessee will exercise a renewal option solely to avoid that adjustment.

In contrast, a TRAC may be structured so as to be virtually certain of resulting in a lessee payment to the lessor if a particular renewal or extension option is not exercised *and* the amount of the payment may be expected to be significant in the context of the lease. In that case, the TRAC is in effect a termination penalty that must be considered when evaluating whether the lessee is reasonably certain to exercise the relevant renewal or extension option. However, even in this case, the lessee is not necessarily reasonably certain to exercise the renewal or extension option. Again, this is because reasonably certain is a high threshold of probability, intended to capture situations in which the lessee is effectively *compelled* to exercise an option.

Ignoring other potential drivers of economic compulsion (see paragraphs 5.2.50 – 5.2.60), the following factors may suggest that even in the face of a virtually certain, significant TRAC payment, the lessee is not reasonably certain to exercise the renewal option (not exhaustive).

- The lessee has the ability to substantially mitigate the economic effect of the TRAC adjustment by reducing its lease costs and other costs related to operating the asset. For example, the economic effect of the TRAC adjustment may be mitigated because the lessee will not make lease payments to the lessor (as it would if it renewed the lease) and, if the asset will not simply be replaced in its operations by a similar asset, will realize operational cost savings such as maintenance, fuel and/or operator labor costs.
- The lessee has a demonstrated history of terminating comparable leases even when such terminations result in significant TRAC payments.
- There are viable alternatives to the lessee that would mitigate the effect of the TRAC adjustment. For example, an alternative vehicle lease provider may offer favorable terms to switch providers that will completely or partially offset the TRAC adjustment, or terminating the lease may permit the lessee to lease a better or more efficient vehicle.

When considering such mitigating factors, an entity should only consider alternatives that presently exist or are likely to arise – i.e. an entity should *not* consider hypothetical or other scenarios that are not likely to arise.

In the absence of mitigating factors, we believe it generally will be reasonably certain that a lessee will exercise an option to renew (or not terminate) a lease subject to a TRAC if:

- the TRAC is structured so as to be virtually certain of resulting in a payment from the lessee to the lessor if the renewal option is not exercised; and
- the payment under the TRAC is expected to be significant in the context of the lease.



### Question 5.3.80

#### **Lease term when the non-cancellable lease period is not fixed**

### **Should an entity reassess the lease term when the non-cancellable period of the lease is not fixed or determinable at lease commencement?**

**Interpretive response:** Yes, both the lessee and the lessor should reassess the lease term when the non-cancellable period of the lease becomes fixed or determinable.

We are aware of certain lease arrangements for which the non-cancellable period of the lease is not fixed or determinable at lease commencement.

For example:

- two parties may enter into an agreement whereby the lessor will lease multiple underlying assets to the lessee, but the non-cancellable period for all of the underlying assets does not become fixed until the last one is deployed and that final date of deployment is unknown when earlier underlying assets are made available for the lessee's use; or
- the non-cancellable period of the lease may be for the duration of a project whose timeline is uncertain at the commencement date.

Section 4.3 discusses potential measurement issues that might arise when there are multiple commencement dates for leases in a single contract (or multiple contracts that are combined for accounting purposes – see section 4.6). However, Topic 842 does not address situations such as those in the preceding paragraph.

For *lessees*, the event that fixes, or makes determinable, the non-cancellable period of the lease may not be something within the control of the lessee (e.g. the lessor's deployment of the final leased asset may be solely within the control of the lessor), and therefore would not trigger a reassessment of the lease term (see section 6.6). For *lessors*, as noted in paragraph 5.3.20, they do not reassess the lease term after lease commencement unless the lease is modified (and that modification is not a separate contract).

Public Board discussions and FASB staff papers concerning reassessments all centered on when, if ever, a lessor should reassess lessee options to extend or terminate a lease. Those discussions and staff papers did *not* discuss circumstances in which the *non-cancellable period of the lease* was not known at lease commencement.

We believe the Board intended for an entity (lessee or lessor) to update an initial assessment of the lease term that was made at lease commencement when the non-cancellable period of the lease was not known at that time. To not update the lease term for this finalization of a key fact (i.e. the non-cancellable period of the lease), including undertaking an assessment of lessee extension or termination options based on the determination of that key fact, could result in counter-intuitive accounting results. For example, the lessor might recognize lease income (or the lessee lease expense) over a period unrelated to even the non-cancellable period of the lease.

Consequently, we believe an entity (lessee or lessor) should update its assessment of the lease term when the non-cancellable period of the lease becomes fixed or determinable if that occurs after lease commencement. This is regardless of (1) the reason why the non-cancellable period of the lease was not known at commencement, or (2) what the change in facts or circumstances is that fixes, or makes otherwise determinable, the non-cancellable period of the lease.



### Question 5.3.90

#### **Lease term when the period of use includes non-consecutive periods of time**

#### **What is the 'lease term' when the period of use comprises non-consecutive periods of time?**

**Background:** The 'period of use' is the total period of time that an asset is used to fulfill a contract with a customer, including the sum of any non-consecutive periods of time. For further discussion of the period of use, see section 3.1.  
[\[842 Glossary\]](#)

As described in Question 3.1.40, a customer does not have to control the use of an identified asset throughout the term of the contract that contains the lease for a lease to exist.

**Interpretive response:** The 'lease term' is the sum of the non-cancellable, non-consecutive periods of time plus any additional non-consecutive periods of time covered by renewal options (1) that the lessee is reasonably certain to exercise or (2) that are controlled by the lessor. Example 5.3.40 illustrates this.

If the sum of those non-consecutive periods of time is 12 months or less, the lease is a 'short-term lease' eligible for the lessee short-term lease recognition exemption if the lessee has elected it (see section 6.3.1). In some circumstances involving a period of use that includes non-consecutive periods of time that qualify for the short-term lease exemption, the lease term will extend over a long period of time (see Example 5.3.40, Scenario 2). As a result, the short-term lease cost incurred during a given period may not reflect the lessee's obligation for the lease. In that case, the lessee discloses that fact and the amount of its remaining short-term lease obligation (see Example 12.2.30).  
[\[842-20-50-8\]](#)



### Example 5.3.40

#### **Lease term when the period of use includes non-consecutive periods of time**

##### **Scenario 1: Seasonal retail lease**

Lessee LE signs a lease with Lessor LR whereby LE will lease a store space in a shopping mall during the holiday season (October 15 through January 15) each year for three years. The lease includes two one-year renewal options under which LE could elect to lease the same store space for the same three-month period for two additional years. LE is not reasonably certain to exercise either one-year renewal option.

In this scenario, both the 'period of use' and the 'lease term' are 9 months – i.e. three months for each year of the three-year contract.

Additionally, for LE, this lease qualifies for the short-term lease recognition exemption because the total lease term is 12 months or less. Changing the facts slightly, if LE were reasonably certain to exercise *both* renewal options so that the lease term would be for 15 months over five years, the lease would not qualify for the short-term lease exemption.

Regardless of whether the lease is eligible for the short-term lease exemption or whether LE elects the exemption, lease cost will be recognized only during the periods of time LE has the right to use the store space. Using the nine-month lease term, the total lease cost will be recognized on a straight-line basis over those nine months with no lease cost recognized between January 16 and October 14 each year of the contract term.

Assume the lease is an operating lease and is recognized on the balance sheet – i.e. the lease is not eligible for, or LE does not elect, the short-term lease exemption. This means that during the months of the contract that no lease cost is recognized, the ROU asset will be increased by the amount of the accretion of the lease liability.

**Note:** If the lease was a finance lease, interest on the lease liability would be recognized in the usual way (see section 6.4.1) – i.e. it would not be added to the carrying amount of the ROU asset. The ROU asset would not be amortized during the periods of time that LE does not have the right to use the store space.

##### **Scenario 2: Stadium lease**

Lessee LE signs a lease with Lessor LR whereby LE will have the right to use LR's stadium for 12 home games per year for 30 years. LE has exclusive rights to the stadium on each game day. The 12 home games each year are not played on consecutive days. There are no renewal options for either party in the contract.

In this scenario, both the 'period of use' and the 'lease term' are 360 days – i.e. 12 days for each year of the 30-year agreement.

Consistent with Scenario 1, lease cost will be recognized only during the periods of time LE has the right to use the stadium. Using the 360-day lease term, the total lease cost will be recognized on a straight-line basis over those

360 days with no lease cost recognized on the other days of the 30-year contract term.

Also consistent with Scenario 1, this lease would qualify for the lessee short-term lease recognition exemption because the lease term is 12 months or less. Given the insignificant portion of the lease term that will occur each year, LE concludes at the end of each year (i.e. until near the end of the contract) that its disclosed short-term lease cost does not reasonably reflect its short-term lease commitment. Therefore, LE discloses that fact and discloses the undiscounted amount of its unpaid stadium lease payments at each annual reporting date.



### Question 5.3.100

#### Mandatory and optional underlying asset replacement

#### How does a lessor obligation or right to replace the underlying asset affect the lease term?

**Background:** In some lease agreements, a lessor may be required or permitted to replace the underlying asset during the lease term to ensure that it continues to meet agreed-upon performance standards. For example, in a 10-year IT service arrangement, the provider may have a replacement right or obligation with respect to one or more of the network infrastructure assets because the economic life is less than 10 years.

**Interpretive response:** The nature of the replacement provision will dictate its effect on the lease term. Three types of replacement provisions are discussed below.

#### Mandatory replacements – replacement date specified

We believe the entity (lessee or lessor) should account for each underlying asset (i.e. the original asset and each replacement asset) as a separate lease component with its own lease commencement date and lease term. This is because the definition of a lease depends on an identified asset (see section 3.2); if the identified asset is changed, the right to control its use is a different lease.

Therefore, if the lessor is obligated to replace the identified asset on a particular date, the term of the initial lease does not extend beyond the specified replacement date. On the date that the replacement asset is made available for the lessee's use, a separate lease commences with its own lease term.

In these scenarios, the lessee should consider disclosing the 'forward-starting' lease. This is because Topic 842 requires a lessee to disclose information about leases that have not yet commenced but that create significant rights and obligations for the lessee. [842-20-50-3(b)]

#### Mandatory replacements – replacement date not specified

In rarer cases, a lessor may commit to replace an underlying asset during the lease term, but not commit to a specific replacement date. In that case, we

believe the term of the initial lease for the original underlying asset should be the shorter of:

- the period of use – i.e. the total period of time over which the lessee will have the right to control the use of the original *and* any replacement assets; and
- the remaining economic life of the original underlying asset at lease commencement.

When the original underlying asset is replaced, the entity should account for the replacement of the identified asset as a lease modification; see section 6.7 (lessees) and section 7.6 (lessors).

### **Optional replacements**

In other cases, a lessor may only have the *option* to replace the underlying asset, rather than an obligation to do so. Despite this difference from the 'Mandatory replacements – replacement date not specified' scenario, we believe the initial lease term should be the same, as should the accounting consequence when and if the lessor replaces the underlying asset.



### Example 5.3.50

#### **Mandatory and optional underlying asset replacement**

##### **Scenario 1: Replacement date specified**

Lessee LE enters into a waste disposal services contract with Lessor LR for 6 years. As part of the arrangement, LE obtains the right to use a dumpster for restaurant waste disposal that meets the definition of a lease (see chapter 3). The contract period is 6 years and the dumpster lease commences immediately. Under the contract, for sanitary reasons, LR must replace the dumpster at the end of Year 3.

At lease commencement, the lease term for the provided dumpster is 3 years. This is the period over which LE controls the use of the identified, original dumpster. The lease term does not extend beyond the specified replacement date of the original dumpster.

Because of the specified replacement date, there are two identified assets – the original dumpster and the replacement dumpster – the leases of which will commence at the beginning of the 6-year contract period and at the end of Year 3, respectively, and each with a 3-year lease term.

##### **Scenario 2: Replacement date not specified**

Lessee LE signs a lease with Lessor LR whereby LE obtains the right to use LR's IT server. The stated duration of the lease is 8 years; however, the lease requires that LR replace the original server after Year 4, with timing at LR's discretion.

The replacement provision is intended to ensure that the leased server does not become obsolete during the 8-year contract period. The added requirement that the replacement cannot occur before the beginning of Year 5 is intended to ensure that the replacement server is viable throughout the remainder of the

contract period. The remaining economic life of the server provided at lease commencement is 5 years.

In this scenario, the lease term is 5 years – i.e. the shorter of the stated contract period (8 years) and the remaining economic life of the server at lease commencement (5 years).

## 5.4 Lease payments



### Excerpt from ASC 842-10

#### **30 Initial Measurement**

##### **General**

> Initial Measurement of the Lease Payments

**30-5** At the **commencement date**, the **lease payments** shall consist of the following payments relating to the use of the **underlying asset** during the **lease term**:

- a. Fixed payments, including in substance fixed payments, less any lease incentives paid or payable to the **lessee** (see paragraphs 842-10-55-30 through 55-31).
- b. **Variable lease payments** that depend on an index or a rate (such as the Consumer Price Index or a market interest rate), initially measured using the index or rate at the commencement date.
- c. The exercise price of an option to purchase the underlying asset if the lessee is reasonably certain to exercise that option (assessed considering the factors in paragraph 842-10-55-26).
- d. Payments for **penalties** for terminating the **lease** if the lease term (as determined in accordance with paragraph 842-10-30-1) reflects the lessee exercising an option to terminate the lease.
- e. Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction. However, such fees shall not be included in the **fair value** of the underlying asset for purposes of applying paragraph 842-10-25-2(d).
- f. For a lessee only, amounts **probable** of being owed by the lessee under **residual value guarantees** (see paragraphs 842-10-55-34 through 55-36).

**30-6** Lease payments do not include any of the following:

- a. Variable lease payments other than those in paragraph 842-10-30-5(b)
- b. Any guarantee by the lessee of the **lessor's** debt
- c. Amounts allocated to nonlease components in accordance with paragraphs 842-10-15-33 through 15-42
- d. Leasehold improvements recognized by a lessee and accounted for in accordance with paragraph 842-20-35-12A.

**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).

**30-8** See Example 25 (paragraphs 842-10-55-225 through 55-234) for an illustration of the requirements on lessee accounting for variable lease payments and Example 26 (paragraphs 842-10-55-235 through 55-238) for an illustration of the requirements on termination penalties.

## 55 Implementation Guidance and Illustrations

### General

- > Implementation Guidance
- > Lease Payments
- • > Guarantees and Indemnifications

**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.

- • • > Obligations to Return an Underlying Asset to its Original Condition

**55-37** Obligations imposed by a lease agreement to return an underlying asset to its original condition if it has been modified by the lessee (for example, a requirement to remove a lessee-installed leasehold improvement) generally would not meet the definition of lease payments or variable lease payments and would be accounted for in accordance with Subtopic 410-20 on asset retirement and environmental obligations. In contrast, costs to dismantle and remove an underlying asset at the end of the lease term that are imposed by the lease agreement generally would be considered lease payments or variable lease payments.

5.4.10 At lease commencement, the lease payments consist of all of the following payments relating to the use of the underlying asset during the 'lease term' (see section 5.3). [842-10-30-5]

Type of payment during the lease term	Subsections
Fixed payments	—
Variable lease payments that depend on an index or rate	5.4.1
Adjustments to fixed payments:	
— in-substance fixed payments (added); and	5.4.2

Type of payment during the lease term	Subsections
— lease incentives paid or payable by the lessor to the lessee (subtracted)	5.4.3
The exercise price of a lessee option to purchase the underlying asset that the lessee is reasonably certain to exercise	5.4.4
Penalties for terminating the lease if the lease term reflects the lessee exercising a termination option	5.4.5
For lessees only, amounts probable of being owed by the lessee under residual value guarantees	5.4.6
Payments by the lessee to the owners of a special purpose entity for structuring the transaction	--

5.4.20 Lease payments do *not* include: [842-10-30-6]

- variable lease payments other than those that depend on an index or rate;
- any guarantee by the lessee of the lessor's debt;
- amounts allocated to non-lease components (see chapter 4); or
- leasehold improvements recognized by a lessee and accounted for in accordance with paragraph 842-20-35-12A on common control leases.

5.4.30 Unless specifically excluded from lease payments under Topic 842 (e.g. a guarantee by the lessee of the lessor's debt – see paragraph 5.4.20), noncash payments relating to the use of the underlying asset during the lease term are included in the lease payments at fair value.

5.4.40 The 'lease payments' for a separate lease component might be an allocated amount when there are multiple separate lease components, or when there is at least one non-lease component. Chapter 4 addresses components of a contract, and outlines the following steps for identifying and allocating contract consideration to the components of a contract that includes one or more leases:

<b>Step 1:</b>	<b>Identify the separate lease components.</b>
<b>Step 2:</b>	<b>Identify any non-lease components – e.g. a maintenance or operating service.</b>
<b>Step 3:</b>	<b>Measure the 'consideration in the contract'.</b>
<b>Step 4:</b>	<b>Separate and allocate the consideration in the contract between the lease and non-lease components (see Example 5.4.10).</b>

5.4.50 An obligation to return an underlying asset to its original condition if it has been modified by the lessee (e.g. a requirement to remove lessee-installed leasehold improvements) does not generally meet the definition of lease payments or variable lease payments. Such obligations are accounted for in accordance with Subtopic 410-20 (asset retirement and environmental obligations). [842-10-55-37]

5.4.60 In contrast, costs to dismantle and remove an underlying asset at the end of the lease term that are imposed by the lease agreement are generally considered lease payments or variable lease payments. Lease payments are

included in the measurement of lease assets and liabilities (see chapter 6 for lessees and chapter 7 for lessors). [\[842-10-55-37\]](#)



### Question 5.4.05

**Costs to dismantle and remove the underlying asset imposed by the lease agreement**

**Should costs to dismantle and remove the underlying asset required by the lease agreement be estimated and included in the lease payments?**

**Interpretive response:** Except as described below, we believe such costs should be estimated by the entity (lessee or lessor) at lease commencement as part of the 'lease payments'. As a result, the costs will be:

- factored into lease classification – 'present value test' (see paragraph 6.2.50); and
- included in the measurement of the lease liability and ROU asset (for the lessee) or lease receivable (for the lessor if a sales-type or direct financing lease).

Randolph P. Green, Professional Accounting Fellow, Office of the Chief Accountant, discussed this topic in a speech given during the 2003 AICPA National Conference on Current SEC Developments. [\[2003 AICPA Conf\]](#)

Where companies have concluded that such an obligation is within the scope of Statement 13, we do not believe that settlement of that obligation is attributable to a contingent event, such as "damage, extraordinary wear and tear, or excessive usage." Nor do we believe that the obligation meets the broader definition of a contingent rental as it results solely from the passage of time and settlement is not based upon "factors on which lease payments are based." In other words, we don't believe the retirement obligation should be treated as contingent rent. The lessee should accrue the expected settlement costs over the lease term if it is an operating lease or include the present value of the estimated cost as part of the asset if it is a capital lease.

While the speech was not given in the context of Topic 842, the guidance about what constitutes a variable lease payment in Topic 842 is essentially unchanged from the guidance about what constituted contingent rent under Topic 840 (formerly FASB Statement No. 13). Therefore, we believe the SEC staff's position remains relevant.

In addition, while the speech specifically referred to lessees only, the relevant guidance about lease payments and variable lease payments in Topic 842 applies to both lessees and lessors. Therefore, we do not believe an entity's accounting for these costs as lease payments or variable lease payments should differ based on whether it is the lessee or the lessor.

**Exception to requirement to estimate and include in lease payments**

We believe that an exception to the above interpretive response arises if the costs will vary on the basis of how, including where and how much, the lessee

uses the asset during the lease term. In that case, the costs are 'variable lease payments', and not estimated at lease commencement.

However, if the lessee's use of the asset cannot result in those costs being \$0, the portion of the costs that is unaffected by that use should be estimated and included in the lease payments.

5.4.70 Section 6.6 outlines when and how a lessee remeasures the lease payments.

5.4.80 A *lessor* remeasures the lease payments only if the lease is modified and that modification is not accounted for as a separate contract (see section 7.6). A lease modification includes a change to the terms and conditions of the contract that contains the lease if that contract modification changes the consideration in the contract, and therefore the lease payments. [842-10-35-6]

5.4.90 In addition to remeasurements in accordance with paragraph 5.4.80, the lease payments for a lessor may also change if there is a change in the consideration in the contract not resulting from a contract modification that is not allocated entirely to the non-lease component(s) of the contract. A change in the contract consideration can result if an estimate of variable consideration was included in that consideration initially (see section 4.3) and either (1) that estimate changes or (2) there is a change in the lessor's consideration of the constraint on variable consideration. In many of the cases where an estimate of variable consideration will be included in the contract consideration, a portion of that estimated variable consideration is included in the lease payments, and therefore a change in that estimate, or a change in the amount of that estimate that is constrained, will change the lease payments (see section 4.4.2).



### Example 5.4.10 Allocated lease payments

Lessee LE and Lessor LR enter into a three-year lease for a piece of equipment. The following additional facts are relevant.

- LR will maintain the equipment over the three-year term.
- In return for the right to use the equipment and LR's maintenance services, LE will make fixed payments of \$100 in Year 1, \$110 in Year 2 and \$120 in Year 3 (\$330 in total).
- The stand-alone price for the lease component is \$280, and for the maintenance services is \$70.

On the basis of these stand-alone prices, the payments of \$330 are allocated between the lease and non-lease components as follows.

Component	Stand-alone price	Allocation	Calculation
Lease (equipment)	\$280	\$264	$(280 / 350) \times 330$
Non-lease (maintenance)	70	66	$(70 / 350) \times 330$
	<b>\$350</b>	<b>\$330</b>	

On the basis of this calculation, the total lease payments are \$264, or 80% of the total. The breakdown of this amount into the different years is calculated using the same proportion as for the total lease payments.

Year	Lease payment	Calculation
1	\$ 80	$100 \times 80\%$
2	88	$110 \times 80\%$
3	96	$120 \times 80\%$
<b>\$264</b>		

#### Question 5.4.10

##### Payments made by the lessee to the lessor to extend the lease term

**Do payments made by the lessee to the lessor to induce the lessor to extend the term of a lease affect the lease payments?**

**Interpretive response:** Yes. All fixed payments to the lessor are included in the consideration in the contract. Therefore, all (if there are no non-lease components of the contract) or a portion (if there are non-lease components of the contract) of the fixed payment will be part of the lease payments for the modified lease.

If the lease is not modified – i.e. the option for the lessee to make the fixed payment in return for the lessor agreeing to extend the lease exists in the original contract – the fixed payment amount is included in the lease payments, and the lease term includes the option period (see paragraph 5.3.10), at the original lease commencement date provided that it is reasonably certain the lessee will exercise its option.

#### Question 5.4.20

##### Effect of lease payments made before commencement date on lease classification

**How are payments made by a lessee to a lessor before the commencement date for the right to use the underlying asset considered when determining lease classification?**

**Background:** Payments (or potentially only a portion of such payments if the contract includes non-lease components) made by a lessee to a lessor before the commencement date are ‘lease payments’ when they relate to the right to use the underlying asset.

In some cases, the prepayments may be made significantly before the lease commencement date. For example, the lessee may be required to make

payments to the lessor while the underlying asset is being constructed. If the lessee is not the accounting owner of the asset (see section 9.4), those payments – or, if the contract includes non-lease components, a portion of those payments – are lease payments.

Under Topic 840, payments made before lease commencement were accreted to their future value at the commencement date when performing the ‘present value’ lease classification test. [840-10-25-6(d)]

**Interpretive response:** Topic 842 does not include explicit guidance like that in paragraph 840-10-15-6(d). However, consistent with that Topic 840 requirement, we believe such amounts should be included in the lease payments used to perform the present value lease classification test (see section 6.2 for lessees and section 7.2 for lessors) at their future value as of the commencement date of the lease, using the same interest rate used to discount the payments to be made after lease commencement (i.e. the ‘discount rate for the lease’ – see section 5.6), to give effect to the time value of money.

Accreting lease prepayments to their future value for purposes of lease classification does not extend to the following:

- recognizing either interest expense (lessee) or interest income (lessor) during the period before lease commencement; or
- calculating the rate implicit in the lease; the calculation (see paragraph 5.6.40) includes the amount of the lease prepayment – not its accreted future value used in the present value lease classification test.

#### Question 5.4.30

#### Payment as consideration for a minimum resale guarantee in a sale contract

#### Is a payment from a customer to a manufacturer as consideration for a minimum resale guarantee in a sale contract included in the ‘lease payments’?

**Background:** A manufacturer sells equipment to a buyer and guarantees the buyer a minimum resale amount on the equipment's disposal. A minimum resale guarantee does not automatically result in a conclusion that the arrangement is a lease (see Question 7.2.10); however, assume that in this case, the guaranteed resale amount creates a significant economic incentive for the buyer to sell the asset such that it is accounted for as a lease. At contract inception, the customer pays the lessor (the manufacturer) a fee or premium to include the guarantee clause in the sales contract.

**Interpretive response:** Yes. Whether a separately stated payment or an overpayment for the asset, that amount is a fixed payment that is part of the consideration in the contract that is allocated to the components of the contract (see chapter 4).

If there are no non-lease components of the contract, the amount will be accounted for as a lease payment in its entirety.



### Question 5.4.40

#### Deposits

**Are deposits paid by a lessee to a lessor at or before the commencement date part of the 'consideration in the contract'?**

**Background:** Lease agreements frequently include requirements for the lessee to remit a deposit to the lessor at or before the lease commencement date. Deposits are usually refundable and represent additional collateral for the lessor. However, they can also be nonrefundable, such as where the deposit represents the lessee's intent to lease the asset.

**Interpretive response:** It depends. If a deposit is nonrefundable, it is a fixed payment no different from any other fixed payments made before the commencement date (see Question 5.4.20). That is, it is part of the consideration in the contract and allocated to the lease and non-lease components in the same manner as the rest of the consideration in the contract.

A deposit is not part of the consideration in the contract when it is refundable. As indicated in the question background, a refundable deposit represents additional collateral for the lessor – e.g. to protect the lessor's interest in the underlying asset. The refundable deposit is held by the lessor to satisfy potential contractual obligations of the lessee, if necessary – such as damages to the underlying asset. Any amount of the refundable deposit not needed to satisfy those potential contractual obligations is refunded to the lessee at the end of the lease term. Because of this, refundable deposits, in addition to any interest earned by the lessor on the refundable deposit, are variable payments that do not depend on an index or rate (see paragraph 4.3.20 and the discussion in paragraphs 5.4.100 – 5.4.140).

## 5.4.1 Variable lease payments



### Excerpt from ASC 842-10

#### 55 Implementation Guidance and Illustrations

##### General

- > Implementation Guidance
- > Lease Payments
- • > Guarantees and Indemnifications
- • • > Indemnification Clauses for Certain Tax Benefits

**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.

**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.

**55-40** Paragraph 842-30-55-16 discusses a lessor's accounting for guarantee payments received.

> Illustrations

- > Illustrations of Lessee Accounting for Variable Lease Payments

**55-225** Example 25 illustrates how a lessee accounts for variable lease payments that depend on an index or a rate and variable lease payments that are linked to performance.

- • > Example 25—Variable Lease Payments That Depend on an Index or a Rate and Variable Lease Payments Linked to Performance

- • • > 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 ( $\$1\text{ million} \div 10\text{ years}$ ).

**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 ( $\$100,000 \times 128 \div 125$ ).

**55-231** 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.

• • • > Case B—Variable Lease Payments Linked to Performance

**55-232** 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.

**55-233** 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.

**55-234** 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.

5.4.100 There are two types of variable lease payments in Topic 842.

- Variable lease payments that depend on an index or rate (such as the CPI, a market interest rate or fair market rent) are *included* in the lease payments. [842-10-30-5(b)]
- Other variable lease payments are *excluded* from the lease payments. [842-10-30-6(a)]

5.4.110 The amount of variable lease payments that depend on an index or a rate that is included in the lease payments is derived using the index or rate at lease commencement. This is because such payments are considered unavoidable. However, the entity should not attempt to forecast future changes in the index or rate. Consequently, the amount included in the lease payments is assumed to remain unchanged from the initial payment over the lease term. This principle is illustrated in Example 5.4.20. [842-10-30-5(b)]

5.4.115 Tax rates are not considered an index or a rate for purposes of identifying variable lease payments that depend on an index or rate. Therefore, payments based on, for example, a property tax mill rate or prevailing sales tax or VAT rates in a net lease (see section 4.2.1) are not variable lease payments that depend on an index or rate. Variable payments of property taxes are discussed further in section 4.2.1. In addition to Example 5.4.80 below, the principle in this paragraph is illustrated in Example 12 (Case A) of Topic 842. [842-10-55-141 – 55-142]

5.4.120 A *lessee* remeasures variable lease payments that depend on an index or a rate only when the lease payments are remeasured for another reason – e.g. a change in the lease term (see section 5.3) or a change in the estimate of

amounts probable of being owed under a residual value guarantee (see section 5.4.6). They are not remeasured as a result of a change in a reference index or rate, even if the payments cannot decrease once they have increased (e.g. if the reference index or rate decreases). [842-10-35-5]

5.4.130 A lessor remeasures variable lease payments that depend on an index or a rate only if the lease is modified and that modification is not accounted for as a separate contract. [842-10-35-6]

5.4.140 The remeasurement of the variable lease payments that depend on an index or a rate is based on the index or rate at the date of remeasurement. [842-10-35-5]

5.4.150 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, they are not of the nature normally expected to arise under variable lease payment provisions. Because of the close association of the indemnification payments to specific aspects of the tax law, any payments are accounted for in a manner that recognizes the tax law association. The lease classification should not be changed. [842-10-55-38 – 55-39]



#### Question 5.4.50

#### **Changes in a reference index or rate as resolution of a contingency**

**Does a change in the reference index or rate upon which variable lease payments depend constitute the resolution of a contingency and trigger a remeasurement of the lease payments?**

**Interpretive response:** No. A change in a reference index or rate does not constitute the resolution of a contingency that triggers a remeasurement of the lease payments (see section 6.6), including variable lease payments that depend on an index or rate. This is the case even if those variable lease payments can never decrease once they have increased – e.g. in the case of a subsequent decrease in the reference index or rate. Further, we do not believe a defined limit to the increases over the lease term alters this conclusion – e.g. a provision stating the lessee's total annual payment during the lease term will never be more than 109% of the total payment during the first year of the lease.



## Observation

### **Impact of excluding variable lease payments from lease payments**

#### **Balance sheet impact**

5.4.160 The Board's decision to exclude most variable lease payments from the definition of lease payments has the following implications for the balance sheet.

- Two leases with very similar economics, but one structured with variable lease payments instead of fixed lease payments (e.g. payments based on the performance or usage of the underlying asset), results in substantially different lease liabilities and ROU assets. The lessee with the fixed payment only lease generally recognizes a larger lease liability and ROU asset throughout the lease term.
- Leases with only variable lease payments do not give rise to any lease liability or ROU asset for the lessee upon lease commencement.

5.4.170 By excluding variable lease payments from the definition of lease payments, the ROU asset and lease liability are less than they would be had an estimate of the variable lease payments been included. As a result, lessees may wish to include a greater proportion of variable lease payments in their lease agreements to minimize the balance sheet effect of Topic 842. In addition, as a result of variable lease payments being excluded, some investors and analysts may unwind the actual lease assets and lease liabilities recorded and estimate their own asset and liability to include variable lease payments, which may require significant effort to make relevant predictions and comparisons.

#### **Income statement and cash flow impact**

5.4.180 In addition to the balance sheet effect, leases with variable lease payments are more likely to be classified as operating leases (by lessees and lessors) because variable lease payments do not factor into the lease classification test (see sections 6.2 for lessees and 7.2 for lessors). Therefore, variable lease payments increase the likelihood that lessees and lessors recognize lease cost or lease income on a straight-line basis (excluding the effect of the variable lease payments) and that lessees recognize their cash payments for leases as operating cash outflows, rather than as a mixture of operating and financing cash outflows.

#### **Identifying variable lease payments is important for disclosures**

5.4.190 Topic 842 includes guidance about items that do not result in variable lease payments (e.g. obligations to return an asset to its original condition, and tax indemnification clauses) because differentiating variable lease payments from other payments affects lessee and lessor disclosures. Lessees and lessors are required to disclose variable lease cost and variable lease income, respectively, such that those disclosures will be inaccurate if an entity misidentifies variable lease payments (see sections 12.2 – 12.3). [842-10-55-37 – 55-38]

### Remeasurement of variable lease payments that depend on an index or rate

5.4.200 The Board's decision not to require the remeasurement of the lease payments for variable lease payments that depend on an index or rate whenever that index or rate changes, or when the contractual cash flows change, was principally a cost-benefit decision. The decision was made as part of the Board's broader effort in the final stages of the project to limit the circumstances in which a lessee would be required to remeasure the lease liability for a lease. [IASU 2016-02.BC236–BC237]

5.4.210 While the Board's decision may reduce the effort necessary to apply Topic 842, it is clear that in many cases the result of this decision is that the lease liability does not reflect the remaining fixed payments required under the lease, increasing the likelihood that investors and analysts will continue to make their own adjustments to reported lease assets and lease liabilities.

5.4.220 Using Example 5.4.20 as an illustration, at the end of December 20X5, if CPI-U increases as expected, the remaining lease payments that will be reflected in the lessee's lease liability in accordance with Topic 842 are \$168,000 ( $\$24,000 \times 7$  remaining payments) even though the lessee is required to make remaining payments of at least \$189,000 ( $\$27,000 \times 7$  remaining payments).



#### Example 5.4.20

#### Variable lease payments that depend on an index or rate

Lessee LE enters into a 10-year lease of space in a shopping center from Lessor LR that commences on January 1, 20X3.

The following facts are relevant.

- Annual payments are calculated as \$100 times December CPI-U, with adjustments set once a year based on the latest December CPI-U. Once payments increase, they do not decrease, even if CPI-U were to decrease. There are no fixed lease payments.
- CPI-U was 230 in December 20X1, and 240 in December 20X2, and is expected to increase to 250 in December 20X3, 260 in December 20X4 and 270 in December 20X5.

The annual payment is measured at \$24,000 ( $\$100 \times 240$ ) – i.e. based on CPI-U at the commencement date. The lease payments over the 10-year lease term are therefore \$240,000 ( $\$24,000 \times 10$ ). The lease payments at commencement do not include any expected increase due to changes in CPI-U during the lease term.

The lease payments are not remeasured for changes in CPI-U unless they are required to be remeasured for another reason – e.g. a change in the lease term or a contract modification that is not accounted for as a separate contract.<sup>1</sup> Therefore, unless the lease payments are remeasured for another reason, the remaining lease payments for the following three years will be:

- at December 31, 20X3: \$216,000 ( $\$24,000 \times 9$  remaining payments);
- at December 31, 20X4: \$192,000 ( $\$24,000 \times 8$  remaining payments); and
- at December 31, 20X5: \$168,000 ( $\$24,000 \times 7$  remaining payments).

Note:

1. A change in a reference index or rate (CPI-U in this example), even in the case where the payments cannot decrease once they have increased (even if the reference index or rate decreases), does *not* constitute the resolution of a contingency that would trigger a remeasurement of the lease payments (see section 6.6), including variable lease payments that depend on an index or rate.



### Question 5.4.60

#### Variable lease payments based on fair market rent

#### Are lease payments that adjust to fair market rent during the lease term considered to be based on an index or rate?

**Background:** Some leases stipulate that the lease payments will be adjusted to fair market rent periodically after lease commencement. For example, a lease may include fixed payments for Years 1–5 of a 10-year term, but specify that the lease payments for Years 6–10 will be adjusted to fair market rent as of the beginning of Year 6.

**Interpretive response:** Yes. While Topic 842 does not specifically identify fair market rent as an index, we believe it meets the definition of an index. We further note that the Board and the IASB reached converged decisions on the measurement of the lease payments at lease commencement and IFRS 16 explicitly states that 'payments that vary to reflect changes in market rental rates' are variable lease payments that depend on an index or a rate. Payments equal to fair market rent at lease commencement are included in the lease payments and are remeasured under the same circumstances and in the same manner as other variable lease payments that depend on an index or rate. [IFRS 16.28]



### Example 5.4.30

#### Payments periodically adjusted to fair market rent

Lessee LE enters into a five-year lease of a 10,000 square foot space in a shopping center from Lessor LR that commences on January 1, 20X1.

The following facts are relevant.

- Annual lease payments for the five-year lease term are fixed at \$2.50 per square foot, which is consistent with market rental rates at the commencement date.
- The lease includes a lessee renewal option for an additional five-year term. Annual lease payments for the renewal period will be set at the beginning of the renewal period based on prevailing fair market rental rates at that date.

- At commencement, LE and LR each determine that it is reasonably certain that LE will exercise the renewal option. Therefore, LE and LR each conclude the lease term is 10 years: the five-year non-cancellable period plus the five-year renewal period.

The lease payments are calculated as follows.

Period	Amount	Calculation
Non-cancellable period	\$125,000	10,000 sq. ft. × \$2.50 × 5 years
Renewal period	125,000	10,000 sq. ft. × \$2.50 × 5 years
<b>Total</b>	<b>\$250,000</b>	

Because the lease payments during the renewal period are variable payments that depend on an index or a rate, those payments are included in the lease payments at the commencement date based on market rental rates at lease commencement.

The payments for the five-year renewal period will not be remeasured, even if (as is likely) fair market rent at the adjustment date (beginning of 20X6) is different from that at lease commencement, unless the lease payments are required to be remeasured for another reason. If no such 'other' remeasurement event occurs, the difference between the \$25,000 amount for each of Years 6–10 included in the lease payments and the amount actually paid will be recognized and disclosed as variable lease cost for that year.



#### Question 5.4.65

##### Variable lease payments that depend on the fair value of the underlying asset

#### Are lease payments that adjust based on the fair value of the underlying asset(s) during the lease term considered variable lease payments that depend on an index or rate?

**Background:** Some leases stipulate that the lease payments will be adjusted based on the fair value of the underlying asset(s) after lease commencement. For example, a lease may include fixed payments for Years 1–5 of a 10-year term, but specify that the lease payments for Years 6–10 will equal a percentage of the fair value of the underlying asset.

**Interpretive response:** In scenarios similar to the background example, we believe lease payments that adjust based on the fair value of the underlying asset(s) should generally be accounted for as variable lease payments that depend on an index. This is for reasons substantially consistent with those in Question 5.4.60 on lease payments that adjust based on fair market rent.

- In that case, the payments that are based on the fair value of the underlying asset are included in the lease payments at lease commencement based on the commencement date fair value of the underlying asset(s); and

- remeasured under the same circumstances and in the same manner as other variable lease payments that depend on an index or rate (see paragraphs 5.4.130 – 5.4.140).

Considering the background example, both the lessee and the lessor will measure the lease payments for Years 6–10 at lease commencement based on the commencement date fair value of the underlying asset. Absent a remeasurement event for either party, the difference between the actual payments for Years 6–10 and the amounts included in the ‘lease payments’ (based on the fair value of the underlying asset at lease commencement) will be accounted for as variable lease payments. If a remeasurement event occurs, the payments that depend on the fair value of the underlying asset will be remeasured based on the fair value of the underlying asset on the remeasurement date.

## 5.4.2 In-substance fixed lease payments



### Excerpt from ASC 842-10

#### 55 Implementation Guidance and Illustrations

##### General

- > Implementation Guidance
- > Lease Payments
- • > In Substance Fixed Payments

**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.

5.4.230 In-substance fixed payments include payments that do not create genuine variability and the minimum payments the lessee is required to make when it has alternative payments that it can select under the lease (e.g. due to optional features within the lease). In-substance fixed payments for a lessee or a lessor might include the following, for example: [842-10-55-31]

- payments that result from clauses that do not have economic substance; or
- the lower of the payments to be made when a lessee has a choice about which set of payments it makes, although it must make at least one set of payments.

5.4.240 In-substance fixed lease payments are included in the measurement of lease payments because they are unavoidable, and therefore economically indistinguishable from fixed lease payments. Although such payments may appear to contain variability, in fact they do not. [IASU 2016-02.BC203]

5.4.250 Topic 842 does not include any explicit statements about reevaluating whether variable lease payments represent in-substance fixed payments. However, we believe that when lease payments are required to be remeasured (e.g. because of a change in the lease term – see section 5.3), this would include reevaluating whether any remaining variable lease payments are in-substance fixed lease payments.

5.4.260 Example 5.4.40 illustrates in-substance fixed lease payments in the context of the lessee having to make one of two possible sets of payments. Examples 5.4.50 and 5.4.60 illustrate in-substance fixed lease payments in the context of variable lease payments.



### Question 5.4.70

#### **Highly certain payments based on performance or usage**

#### **Should variable lease payments that are highly certain to occur be treated as in-substance fixed lease payments?**

**Interpretive response:** No. As illustrated in Example 5.4.80, we believe that even variable lease payments that are highly (or even virtually) certain to occur are not in-substance fixed lease payments if the payments are based on performance or usage of the underlying asset. This is consistent with practice under Topic 840, and therefore with the Board's statement that the concept of in-substance fixed lease payments under Topic 842 is intended to be consistent with previous practice under Topic 840.

In addition, while not included in Topic 842 and therefore not authoritative, the publicly available FASB staff paper that guided the Board's discussion in April 2014 of in-substance fixed lease payments included an example substantially similar to Example 5.4.80; the Board discussion generally indicated support for the conclusion reached in that example.



### Example 5.4.40

#### **Two possible sets of lease payments**

Lessee LE enters into a seven-year lease of land and a building.

The following facts are relevant.

- The lease requires monthly fixed lease payments of \$14,000 and variable lease payments that are determined as 10% of LE's annual sales in excess of \$1,000,000.
- At the end of the seven-year period, if sales are at least \$1,500,000 in each of the last five years of the lease term, LE has the option to purchase the

property for \$400,000. At the lease commencement date, LE is not reasonably certain to exercise this purchase option.

- If sales are less than \$1,500,000 in any of the last five years of the lease, LE is required to purchase the property for \$400,000 at the end of the seven-year period.

The lease payments under each scenario are calculated as follows.

Payment	Sales ≥ \$1.5m	Sales < \$1.5m	Calculation
Fixed	\$1,176,000	\$1,176,000	$\$14,000 \times 12 \text{ months} \times 7 \text{ years}$
Minimum variable	250,000	-	$(\$1,500,000 - 1,000,000) \times 10\% \times 5 \text{ years}$
Purchase price	-	400,000	
<b>Total</b>	<b>\$1,426,000</b>	<b>\$1,576,000</b>	

The \$1,426,000 (which assumes sales are at least \$1.5 million per year in the last five years) is lower than \$1,576,000 (which assumes sales are less than \$1.5 million in any of the last five years, and therefore that LE must purchase the property for \$400,000). LE must pay either \$1,426,000 or \$1,576,000. Therefore, the lease payments are \$1,426,000 (see paragraph 5.4.230).



### Example 5.4.50

#### Variable lease payments without economic substance

Lessee LE enters into a 10-year lease of a warehouse from Lessor LR.

The following facts are relevant.

- Lease payments are initially \$200,000 per month in arrears.
- The lease payments increase by 1% annually for every 0.1% increase in CPI from the prior year (resulting in a leverage factor of 10 times the change in CPI), limited to a maximum increase of 2% per year.
- Once variable lease payments increase, they cannot decrease under the terms of the lease.
- The CPI increase has exceeded 1% in each of the previous 20 years and there is only a remote likelihood that annual CPI increases will be less than 0.2% during the term of the lease.

If payments under the CPI escalation provision are considered variable lease payments, no increase in rents over the lease term will be included in the lease payments. This is because, absent a remeasurement event (e.g. a change in the lease term), the measurement of the lease payments for the entire lease term would be performed using the CPI index at lease commencement – i.e. \$200,000 per month.

However, in this example, the payments under the CPI escalation provision are in-substance fixed payments, rather than variable lease payments, because of

the remote likelihood that the change in CPI will be less than 0.2%. Therefore, both LE and LR include a 2% annual increase in the measurement of lease payments at the lease commencement date.



### Example 5.4.60

#### **Variable lease payments vs. in-substance fixed lease payments – payments based on performance or usage**

Lessee LE and Lessor LR enter into a seven-year lease of retail space.

The following facts are relevant.

- The lease requires monthly variable lease payments equal to 5% of sales from the retail space. There are no fixed lease payments.
- LE has an established, successful brand and similar retail stores in similar shopping centers in many locations.
- Based on LE's extensive, relevant history of operating similar stores, LE and LR can reliably forecast that LE will generate *at least* \$500,000 in sales from this store each year of the seven-year lease; therefore, it is highly certain that LE will make at least \$25,000 in variable lease payments each year ( $\$500,000 \times 5\%$ ). In fact, LE and LR each have forecasts for a much greater amount of sales each year.

The lease payments are nil for this lease. This means that LE will have no ROU asset or lease liability for this lease at the commencement date; and if this were a sales-type or direct financing lease, LR would have no lease receivable. This lease would be classified as an operating lease unless the carrying amount of the space at the commencement date is \$0.

Despite the fact that LE is highly certain to make at least \$175,000 ( $\$25,000 \times 7$ ) in variable lease payments over the lease term, those variable payments are not in-substance fixed payments. The variable terms have economic substance – i.e. they exist as a substantive way for LE and LR to share in the risks and benefits from use of the retail space – and create genuine variability in the lease payments to be made.



### Example 5.4.70

#### **Protective provisions in lease payments**

Lessee LE enters into a contract with Lessor LR whereby LR will operate and maintain a specified machine it owns on behalf of LE. LE and LR determine the contract is a lease under Topic 842. The term of the lease is three years.

The following facts are relevant.

- Payments from LE to LR are based on the daily operating status of the machine throughout the term of the lease.

- For each day that LR operates the machine, LE is required to pay \$2,000 for its use and LR's operations and maintenance services.
- If the machine is operational and LR is available to operate the machine, but no operations occur (e.g. because LE did not instruct LR to operate the machine on a given day), a standby rate of \$1,700 applies.
- If the machine is not operational, which occurs for a variety of reasons for short periods of time, a daily maintenance rate of \$1,500 applies up to a specified number of contract days. However, if nonoperational days exceed that number, the daily rate for those days is \$0. Zero-rate days occur in most contracts.

To calculate the lease payments for both LE and LR, it is necessary to analyze the different payments.

- **Maintenance days.** The maintenance rate of \$1,500 represents the daily fixed payment. Nonoperational days that will be subject to the maintenance rate are expected for contracts of this nature such that there is genuine variability between the maintenance rate and the full operating rate.
- **Operating and standby days.** Amounts paid above \$1,500 per day on operating and standby days (\$500 and \$200, respectively) are variable payments that do not depend on an index or rate.
- **Nonoperational days in excess of the contractually stipulated limit.** Even though there are circumstances under the terms of the contract where LE may not be obligated to pay a daily rate to LR, the \$0 rate for nonoperational days in excess of the contractually stipulated limit is considered a protective provision for LE – i.e. it is intended to hold LE harmless when the machine is not available and operational for an excessive period of time for reasons outside LE's control. In contrast to the \$0 rate, the difference between the maintenance rate of \$1,500 and the full operating rate of \$2,000 reflects genuine economic variability in the contract given that maintenance events occur regularly for this type of machine, operating under similar conditions.

The maintenance rate is the lowest economic rate in the contract that does not reflect a protective provision for LE; it reflects the daily fixed payment. Therefore, the annual consideration in the contract is \$547,500 ( $\$1,500 \times 365$  days). This amount is allocated among the lease and non-lease (operations and maintenance services) components of the contract (see section 4.4).

Any variable amounts resulting from operating or standby days (\$500 and \$200, respectively) are allocated to the lease and non-lease components (see section 4.4), and recognized when earned. Days for which the \$0 rate applies are accounted for as negative variable lease cost (lessee) or negative variable lease income (lessor).

**Note:** Protective rights in a contract are intended to protect a supplier's interest in its asset or personnel, but do not necessarily prevent a customer from having the right to direct the use of an asset. The same concept can be applied to lessees whereby the protective right is meant to protect against substantial nonperformance by the lessor or circumstances outside the control of the lessee. Identifying protective provisions and related in-substance minimum fixed payments that are not protective requires judgment. The view that

protective provisions should be ignored when determining the 'lease payments' under Topic 842 has been confirmed by the FASB staff. [842-10-15-23]



## Example 5.4.80

### Substantive variability in lease payments

#### Scenario 1: Lessee operates in jurisdictions with and without sales taxes

Lessee LE enters into a five-year lease agreement with Lessor LR for 20 commercial delivery trucks that LE will use in its delivery business that operates across the United States. Under the terms of the lease agreement, LE makes fixed lease payments to LR of \$20,000 per year for each leased truck.

Additionally, LE is required to reimburse LR for sales taxes that LR incurs related to the trucks over the term of the lease.<sup>1</sup> In this transaction, the sales taxes arise for LR based on where LE operates the trucks (e.g. whether the trucks operate in a jurisdiction with a sales tax or not) and how much LE operates those trucks in that jurisdiction. Based on the nature of LE's business, it will operate the trucks in different capacities across the contiguous 48 US states throughout the term of the lease. Sales tax rates vary by state, and some states have no sales taxes. Therefore, the amount of sales taxes that LR will incur (and LE will reimburse) will vary from period to period during the lease. The reimbursement of LR's sales tax obligations does not provide a good or service to LE, and therefore is not a component of the contract (see section 4.2).

Note:

1. In this example (all scenarios), it is assumed the sales taxes are LR costs (see section 4.2.1) and LR does not elect the practical expedient for sales and other similar taxes (see paragraph 4.2.200).

There are no other components of the contract – e.g. maintenance of the trucks.

The total lease payments are \$400,000, analyzed as follows.

- **Fixed payments.** The fixed annual lease payments under the lease agreement are \$400,000 ( $\$20,000 \times 20$  trucks). These are fixed lease payments for both LE and LR, so \$2,000,000 in total ( $\$400,000 \times 5$  years).
- **Reimbursement of sales taxes.** The amount LR will incur (and LE will reimburse) will vary from period to period during the lease based on LE's use of the trucks and the sales tax rates in each state (which can be changed at any time and for any reason by the relevant taxing authority). Therefore, the amount LE will reimburse to LR for sales tax obligations is variable. Because there are only lease components of the contract (20 truck leases and no other components), the sales tax reimbursements are all variable *lease* payments. Those variable lease payments do not depend on an index or rate (see paragraph 5.4.115) – they depend on both (1) LE's decisions about where to operate the trucks and (2) the various states' decisions about whether and how much sales tax to charge. Therefore, the sales tax reimbursements are not part of the lease payments.

**Scenario 2: Lessee operates only in jurisdictions that currently have a sales tax**

Assume the same facts as in Scenario 1, except that LE only has operations in a limited number of states that all currently impose sales tax. In addition, the sales tax obligation that LR will incur does not depend on how much LE uses the trucks; instead, the sales tax obligation incurred by LR is based on the periodic gross lease payment from LE to LR and where the truck was located during the billing period.

Consistent with Scenario 1, LE and LR conclude that there is not a fixed minimum amount of sales tax that LE will be required to pay. This is because even though the trucks will only be located in jurisdictions that presently impose a sales tax, those payments are not unavoidable at lease commencement. Each state in which the trucks will reside during the lease term has the ability to change its sales tax rate or eliminate its sales tax entirely at any time and for any reason (or no reason). Consequently, LR may not incur, and therefore LE may not be required to reimburse, any sales tax.

**Scenario 3: Lessee makes payments intended to reimburse lessor costs of taxes and registration based on contractual rates**

Assume the same facts as in Scenario 2, except that, rather than reimburse LR for actual sales tax incurred, the variable payments that depend on the trucks' locations during the billing period are based on a rate table in the contract between LE and LR. The rate table will not change during the lease term unless the contract is modified.

In this scenario, LE and LR determine that there is a fixed minimum that LE will be required to pay that does not depend on LE's use of the trucks, calculated assuming the lowest possible rate in the contract rate table that could apply. That minimum amount is unavoidable, and therefore economically fixed. Payments each month in excess of that unavoidable minimum amount are variable lease payments.

Note that even if LR had elected the sales and other similar taxes practical expedient (see Note 1), it would not apply to the variable payments that depend on the trucks' locations in this scenario and Scenario 4, because the variable payments do not depend on actual sales taxes incurred, even though they have the primary purpose of reimbursing LR for its sales tax costs.

**Scenario 4: Lessee payments depend on operating the trucks**

Assume the same facts as in Scenario 3, except that LR would not owe any variable payments (i.e. those based on the contract rate table) if LE does not operate the trucks.

In this scenario, even if LE is virtually certain to operate the trucks every month, LE's payments based on the contractual rate table would all be variable lease payments, like in Scenarios 1 and 2; there would be no in-substance fixed minimum amount of those payments.



## Observation

### **Concept of in-substance fixed lease payments consistent with previous US GAAP**

5.4.270 The guidance in Topic 842 relies on a principle rather than a series of more detailed requirements or examples, because the Board concluded that even an exhaustive list of requirements or examples could never be comprehensive. In addition, the Board concluded that introducing a new series of detailed requirements or examples might create new questions or issues for a concept that was generally understood and applied before the issuance of Topic 842.

5.4.280 Consistent with that thinking, the Board's intent is for the Topic 842 guidance on in-substance fixed lease payments to be applied in substantially the same manner as it was applied under previous GAAP. Therefore, previous examples of what constitute in-substance fixed (or disguised or de facto) minimum lease payments continue to be relevant under Topic 842.

[ASU 2016-02.BC204]

## 5.4.3 Lease incentives



### **Excerpt from ASC 842-10**

#### **55 Implementation Guidance and Illustrations**

##### **General**

- > Implementation Guidance
- > Lease Payments
- • > Lease Incentives

**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.

5.4.290 The lessor may offer incentives to the lessee to sign the lease agreement. Lease incentives include both: [842-10-55-30]

- payments made to or on behalf of the lessee; and
- losses incurred by the lessor as a result of assuming a lessee's pre-existing lease with a third party.

5.4.300 Regarding losses attributable to the lessor assuming a lessee's pre-existing lease, the lessor and lessee should prepare independent estimates. For example: [842-10-55-30]

- The lessee's estimate of the incentive could be based on a comparison of the new lease with the market rental rate available for similar underlying assets, or the market rental rate from the same lessor without the lease assumption.
- The lessor should estimate any loss based on the total remaining costs reduced by the expected benefits from the sublease for use of the assumed underlying asset.

5.4.310 Consistent with other components of lease payments, lease incentives may be an allocated amount. That is, a lessor may grant incentives to a lessee in a contract that includes lease and non-lease components. All incentives, however characterized (i.e. as a lease incentive or otherwise), reduce the consideration in the contract (see section 4.3), which is allocated to the components of the contract either on a relative stand-alone price basis (lessees) or in accordance with the transaction price allocation guidance in Topic 606 (lessors). Consequently, a portion of amounts characterized as lease incentives may not be accounted for as such (i.e. may be allocated to a non-lease component) and vice versa.

5.4.320 Section 4.3 discusses in further detail what constitutes an incentive that reduces the consideration in the contract.

5.4.330 Lease incentives may be structured to be contingent on future events or lessee actions. For example, a lessor may agree to reimburse a lessee for the cost of leasehold improvements, with payment contingent upon the lessee's construction or installation of the improvements. See Question 6.6.80 for further discussion on how a lessee accounts for contingent lease incentives.

## Question 5.4.80



### Determining the accounting owner of leasehold improvements

#### Does the determination of the accounting owner of leasehold improvements affect the accounting for a lease?

**Interpretive response:** Yes, in multiple respects.

##### Effect on the 'consideration in the contract'

All payments made by a lessor to a lessee are an incentive, reducing the consideration in the contract, unless the payments are for a distinct good or service provided by the lessee to the lessor (e.g. for construction of, or managing the construction of, the lessor's assets). In addition, even if the lessee provides a distinct good or service to the lessor, any amount of the

lessor's payments in excess of the fair value of the distinct good or service is an incentive. [842-10-15-35(a), 606-10-32-25 – 32-26]

Therefore, lessor payments to the lessee for leasehold improvements are incentives, reducing the consideration in the contract when the leasehold improvements are assets of the lessee for accounting purposes – i.e. they are not a payment for a distinct good of the lessor in that case.

### **Effect on lease commencement**

As outlined in section 5.1 (in particular, see Example 5.1.10), the accounting owner of leasehold improvements may determine the lease commencement date.

Paragraph 5.1.20 discusses the possible accounting effects of an improperly determined lease commencement date.

### **Determining the accounting owner**

We believe the factors outlined below (not exhaustive) provide relevant evidence about whether the lessee or the lessor is the accounting owner of specified leasehold improvements. These factors generally consider the question of accounting ownership from a 'control' perspective – i.e. which party has the ability to direct the use of, and obtain substantially all the remaining benefits from, the asset.

This is on the basis that the principle of control generally underlies the questions of accounting ownership elsewhere in Topic 842 – e.g. the sale-leaseback guidance in Subtopic 842-40 (including that related to control of an underlying asset before lease commencement). [842-40-25-1(b), 55-1 – 55-5]

- If the 'lease term' (see section 5.3) for the underlying asset (e.g. the leased building or space) is for at least substantially all of the economic life of the improvements, that would typically be a strong indicator that the lessee is the accounting owner of the improvements *if* the lessee will have exclusive use of the improvements and the ability to direct their use during the lease term.

Lessee options to renew the lease that are *not* included in the lease term, but if exercised would extend the lease such that it is for at least substantially all of the economic life of the improvements, may also affect the accounting owner evaluation. This is because those options, in effect, give the lessee the unilateral right to extend the period over which it has exclusive use – and the ability to direct the use – of the improvements for substantially all of their economic life.

- If the lessee is likely to exercise options that would extend the lease to substantially all of the improvements' economic life, that means it is *unlikely* the lessor will ever be able to direct the use of, or obtain substantial benefits from, the improvements during their economic life. 'Likely' is a lower threshold than 'reasonably certain' (see section 5.2) but refers to a probability greater than more likely than not.

In the context of a binary accounting owner evaluation – i.e. between the lessee and the lessor – we believe this is a relevant consideration.

- In contrast, if the lessee is not likely to exercise options that would extend the lease to substantially all of the improvements' economic life,

other factors, such as those that follow, are likely to influence the evaluation more significantly than the lessee's renewal options.

- Whether the terms of the lease agreement require the lessee to construct or install the improvements. If the provisions of the lease do not require the lessee to construct or install the improvements, that would indicate the lessee controlled whether or not to construct or install them. It would therefore follow that the lessee likely would not undertake that investment if it were not able to direct the use of those improvements and obtain substantially all their remaining benefits.

In evaluating whether the lease agreement requires the lessee to construct or install specific leasehold improvements, an entity should consider the consequences to the lessee if the lessee fails to construct or install the specified improvements (e.g. whether such failure is a default under which the lessor can require specific performance by the lessee or recover monetary damages).

- If the provisions of the lease permit the lessee to remove or alter the improvements without the lessor's consent or without adequately compensating the lessor for any corresponding reduction in utility or value of the underlying asset (other than returning the underlying asset to its original condition before construction or installation of the leasehold improvements), that indicates the lessee has the ability to direct the use of the improvements (e.g. retain them or discard them) and the sole ability to obtain substantially all their remaining benefits.
- If the lessee is not permitted to remove or significantly alter the improvements without the consent of the lessor, but the lessor must pay the lessee an appropriate fee for them at the end of the lease if they are not permitted to be removed, that would generally suggest the lessee will either (1) have control on a basis consistent with the preceding factor or (2) have the ability to direct the use of the assets until the end of the lease and at that point receive substantially all the remaining benefits from the asset (in the form of the payment from the lessor), which can be used to acquire substantially equivalent assets.
- If the leasehold improvements are highly specialized such that neither the lessor, nor another lessee, would likely be able to derive significant economic benefit from the improvements after the end of the lease, that would suggest, similar to the basis for the 'alternative use' lease classification criterion, that the lessee is directing the use of the asset throughout the period during which substantially all of the remaining benefits of the improvements will be consumed. [842-40-25-2(e)]

Other considerations, such as who holds legal title to the improvements, who has an insurable interest in the improvements, who has tax basis in the improvements and who has the significant risks of ownership do not, in isolation, determine the accounting owner of the improvements.

Sometimes, a lessor pays the costs of constructing leasehold improvements directly to a third party rather than reimbursing the lessee for those costs. We do not believe the identity of the party that constructs the leasehold improvements (i.e. the lessee, the lessor or a third party) directly influences the accounting ownership assessment. This is because the lessee could have

substantially similar rights to control third-party constructed leasehold improvements (for which the lessor pays the costs to the third party directly) as it does improvements that it constructs or that are constructed by a third party for which the lessee is the primary obligor to the third party.

The contracting mechanism (i.e. between the lessee and the third party or between the lessor and the third party) and the payment terms (i.e. lessor pays the third party or lessee pays the third party) should generally not be determinative; the lessor could contract and pay for lessee-controlled leasehold improvements as an incentive in lieu of providing a cash payment to the lessee.



#### Question 5.4.81

#### **Accounting owner of structural leasehold improvements**

#### **Is the lessor automatically the accounting owner of structural leasehold improvements?**

**Background:** Question 5.4.80 discusses considerations relevant to determining the accounting owner of leasehold improvements, and indicates that judgment is frequently required. It also discusses the accounting effects of that determination.

Since the adoption of Topic 842, questions have frequently arisen in practice around 'structural' leasehold improvements. Structural leasehold improvements include (not exhaustive) HVAC systems, electrical or plumbing infrastructure and elevators that are typically integrated into a leased building (or part of a building). Because of their integration into the lessor's owned building, some entities have assumed that those improvements must be lessor-owned for accounting purposes.

**Interpretive response:** No. The lessor is not automatically the accounting owner of structural leasehold improvements. The same principle and considerations that apply to other leasehold improvements apply to structural leasehold improvements (see Question 5.4.80). Depending on the facts and circumstances, the accounting owner of structural leasehold improvements may be the lessee or the lessor.

Example 5.4.85 illustrates applying the framework in Question 5.4.80 to structural leasehold improvements.



### Example 5.4.85

#### Determining the accounting owner of structural leasehold improvements

##### Scenario 1: Non-cancellable lease term equals economic life of the improvements

Lessee LE and Lessor LR enter into a 15-year non-cancellable lease for a building LE will use as a manufacturing facility. LE makes, and pays for, significant improvements to the facility for its specific manufacturing and production needs. These improvements include a new and advanced HVAC and air filtration system. LE selects and purchases the system.

Other facts relevant to determining the accounting owner of the HVAC and air filtration system include the following.

Renewal/purchase options:	None
Economic life of new HVAC/filtration system:	15 years
End of lease requirements for the HVAC/filtration system:	LE is not permitted to remove; LR is not required to make any payments to LE.
Alternative use to LR at end of lease:	Yes, this HVAC/filtration system would be usable by other types of building occupants; while an advanced system, it would service occupants with lesser needs and potentially be attractive to future occupants with similar needs for an advanced HVAC/filtration system.
LE rights to remove or modify the HVAC/filtration system during the lease term:	LE can modify or change the system during the lease term provided that a functioning HVAC/filtration system generally equivalent to that in the building when LE took possession thereof remains at the end of the lease.
LR rights to remove or modify the HVAC/filtration system during the lease term:	None. LR cannot remove or replace the system without LE's agreement during the lease term.

That the HVAC/filtration system will be installed (integrated) into LR's owned building raises the question of whether LR is the accounting owner of the system.

However, LE and LR each conclude that LE is the accounting owner of the HVAC/filtration system in this scenario. In reaching this conclusion, the parties conclude that LE has the ability to direct the use of and obtain substantially all of the remaining benefits from the system. This is for the following reasons.

- The non-cancellable lease term for the building equals the economic life of the system. Therefore, LE has the right to direct the use of the system – i.e. through its control over the use of the building, it will control when, whether, how and how much the system is used – for its entire economic life. LE, throughout the building lease term, will decide the temperature, humidity, filtration and other operational settings of the system.

- In addition, while LE can modify or change the system during the lease term, LR has no rights to remove, replace or render the system inoperable.

**Scenario 2: Non-cancellable lease term is significantly less than the economic life of the improvements – lessee has renewal options (1)**

Assume the same facts as in Scenario 1, except that the non-cancellable lease term is five years (instead of 15 years). LE has three, three-year renewal options that make the maximum possible lease term, at LE's sole option, 14 years.

There are no contractual or other impediments to LE exercising one or all of those renewal options – e.g. off-market rental payments, onerous covenants or one-time fees/charges.

***LE is likely to exercise all three renewal options***

LE's significant investment in the HVAC/filtration system, which LE would be expected to need in any alternative manufacturing facility, is an economic factor that may make it *at least* likely that LE will exercise one or more of its renewal options in the contract. Because of this and/or other economic factors, LE may be at least likely to exercise all three renewal options; 'likely' is a lower threshold of probability than 'reasonably certain' (see section 5.2).

In that case, LE and LR would likely reach the same conclusion as that reached in Scenario 1. This is because, given the other relevant facts in this scenario, it is unlikely LR will be able to derive any substantial economic benefits from the system at the end of the lease or ever obtain the right to direct its use during its economic life.

***LE is not likely to exercise all three renewal options***

Economic factors other than LE's investment in the HVAC/filtration system may mean LE is not likely to exercise all of its renewal options. In that case, the duration of the lease may be substantively less than the economic life of the system.

In this scenario, at 5 – 11 years, it will comprise only 33% – 73% of the system's economic life. Despite this, LE and LR may still conclude that LE is the accounting owner of the system based on the totality of the following.

- LE was not required by the contract to upgrade the building's HVAC/filtration; LE elected to do so for its own manufacturing needs.
- LE selected the system to be installed.
- LE is permitted to remove or modify the system during, or at the end of, the lease term, as long as the building is returned to LR in the same condition as when LE occupied it – i.e. with less advanced HVAC and air filtration equipment. Note that for cost and portability of the system reasons, it is unlikely LE would remove or substantially modify the system once it is installed, including at the end of the lease.
- LE's rights to direct the use of the system during the non-cancellable lease term and any renewal periods are identical to those in Scenario 1, and LE's renewal options give it the right to continue to do so for substantially all of the system's economic life. LR, by contrast, can only direct the use of the system and obtain substantial remaining benefits therefrom (or permit

another lessee to do so) if LE elects not to exercise one or more of its renewal options and leaves the system intact at the end of the lease.

The following factors, which assume LE does not exercise all of its renewal options and leaves the system intact at the end of the lease, are not strong enough to override those above.

- LR would likely be able to derive significant economic benefit from the improvements after the end of the lease.
- LR does not have to compensate LE for the system's remaining economic value.

### **Scenario 3: Non-cancellable lease term is significantly less than the economic life of the improvements – lessee has renewal options (2)**

Assume the same facts as in Scenario 2, except that:

- LR was required to be consulted on, and approve, the system and the installation contractor;
- once installed, LE is not permitted to remove or modify the system without LR's approval; and
- LE must operate the system within certain parameters designed to ensure the system's longevity and performance (and must pay for repairs or maintenance if it does not).

The changed facts indicate that LE's rights to direct the use of the system during the lease term are more limited than in Scenario 2. In addition, LR had more influence over the system's specifications and installation, affecting the benefits able to be derived from the system over its economic life. Lastly, the operating parameters on LE in effect assure LR that it will be able to derive significant economic benefits from the system at the end of the lease if LE does not exercise all of its building lease renewal options.

#### ***LE is likely to exercise all three renewal options***

These changed facts notwithstanding, if LE is still likely to exercise all three of its building lease renewal options, LE and LR would likely reach the same conclusion as that reached in Scenario 2.

Despite restrictions on LE's ability to direct the use of the system in this scenario, those restrictions are protective in nature – e.g. to ensure LR does not have to incur an expense to repair or replace the system at the end of the lease if LE does not exercise all of its renewal options; and LE is likely to obtain substantially all of the system's economic benefits.

#### ***LE is not likely to exercise all three renewal options***

If LE is not likely to exercise all three of its renewal options, LE and LR would likely conclude that the system is a LR-owned improvement in this scenario. This is because:

- LR would be able to derive significant economic benefits from the system after the end of the lease, for which it does not have to compensate LE; and

- LE is prohibited from removing or modifying the system and must operate the system during the lease term in a manner designed to preserve those remaining benefits for LR.

**Scenario 4: Non-cancellable lease term is significantly less than the economic life of the improvements – no lessee renewal options**

Assume the same facts as in Scenario 2, except that the non-cancellable lease term is seven years and LE has no renewal or extension options – i.e. the maximum possible lease term under the contract is seven years. In addition, LR provides LE with cash lease incentives intended to fund much of LE's build-out (including the new HVAC/filtration system).

In this scenario, LE and LR each conclude that LR is the accounting owner of the system; LE does not have the ability to direct the use of and obtain substantially all of the remaining benefits from this system. LE and LR each reach this conclusion based on consideration of the following factors.

- LE has the ability to benefit from the system for only 7 years of its 15-year economic life;
- LE cannot remove and continue to use and benefit from the system at the end of the lease; and
- LR is not required to compensate LE for the significant remaining economic value of the system at the end of the lease.

In contrast, LR will have the right to the significant remaining economic benefits of the system installed in its building at the end of the lease, and will be able to benefit from the advanced system – which is not useful only to LE – in marketing the building (for lease or sale) to others.



**Question 5.4.85**  
**Lessee payments for leasehold improvements owned by the lessor**

**How should an entity account for payments by the lessee for lessor-owned leasehold improvements?**

**Interpretive response:** When the lessor is determined to be the accounting owner of improvements to the underlying asset (see Question 5.4.80), lessee payments for those improvements are either:

- fixed payments, and therefore included in the 'consideration in the contract'; or
- variable payments excluded from the consideration in the contract.

Making a payment for a lessor-owned asset (i.e. the improvements) is substantively no different from making a cash payment to the lessor. Whether the payment is a fixed payment or a variable payment depends on the facts and circumstances.

**Fixed payment**

If the contract stipulates a fixed amount the lessee must pay for (or toward) the lessor-owned improvement(s), that amount is included in the consideration in

the contract at lease commencement. All or a portion of the amount (i.e. if there are non-lease components not combined with the lease component) will be a 'lease payment'; the exception being if the entity is the lessor, and it is accounting for the lease as part of a single Topic 606 performance obligation (see paragraph 4.4.53).

### Variable payment

If the contract requires the lessee to pay for a lessor-owned improvement, but the amount is unknown at lease commencement, such payments are variable payments that do not depend on an index or rate. Therefore, they are not included in the consideration in the contract at lease commencement.

The following occurs once the variable payment amount becomes fixed.

- The **lessee** remeasures the consideration in the contract for the resolution of that contingency (see paragraphs 6.6.90 and 6.6.140).
- In addition to recognizing its owned asset improvements, the **lessor** recognizes (see paragraphs 7.3.140 and 7.4.20):
  - the amount allocable to the lease component as variable lease revenue (unless the amount the lessee will pay is a reimbursement to the lessor of the nature described in Question 7.4.20); and
  - any amount allocable to non-lease components when the requirements of the applicable Topic (e.g. Topic 606) are met.

### Contract silent at lease commencement

The contract may be silent with respect to lessor-owned improvements, and therefore there is no accounting at lease commencement. If lessor-owned improvements are subsequently constructed or installed, and the lessee is required to pay for them (which includes costs incurred by the lessee – e.g. if the lessee uses its own personnel to construct or install the improvements), we believe that is a lease modification. This new requirement changes the consideration in the contract, which now includes the amounts paid (or required to be paid) for the lessor-owned improvements. See sections 6.7 (lessees) and 7.6 (lessors) for guidance on accounting for lease modifications.



### Example 5.4.90

#### Impact of lease incentives on lease payments

Lessee LE and Lessor LR enter into a 10-year lease with the following terms:

- Annual rent of \$1,500, so \$15,000 in total.
- LR agrees to provide LE with \$1,000 to defray the cost of tenant improvements each of the first three years of the lease, so \$3,000 in total. LE will simply reduce its annual payment for Years 1–3 by \$1,000 each year.

The lease payments are \$12,000 in this example (\$15,000 – \$3,000 incentive). LE will need to factor in the timing and amount of its payments in determining lease classification (see section 6.2), and in measuring its lease liability (see section 6.3).

Therefore, the present value of those lease payments is based on:

- Years 1–3: annual lease payment of \$500.
  - Years 4–10: annual lease payment of \$1,500.
- 

#### 5.4.4 Purchase options

5.4.340 The exercise price of a lessee option to purchase the underlying asset is included in the lease payments if the lessee is reasonably certain to exercise the option. The analysis of whether a lessee is reasonably certain to exercise a purchase option considers the same economic factors that are evaluated in determining whether to include optional periods in the lease term (see section 5.2). [842-10-30-5(c)]

5.4.350 When there is a change in the assessment of whether it's reasonably certain that the *lessee* will exercise a purchase option, the lessee remeasures the lease payments. Reassessments of lessee purchase options and remeasurements of the lease payments resulting from a change in the assessment of a lessee purchase option are discussed in section 6.6. [842-10-35-4(c)(2)]

5.4.360 A *lessor* does not reassess whether the lessee is reasonably certain to exercise a purchase option unless the lease is modified and that modification is not accounted for as a separate contract (see section 7.6). [842-10-35-3]



#### Example 5.4.100

##### Purchase option price included in lease payments

Lessee LE leases a warehouse and land. The following facts are relevant.

- The lease term is five years, with annual fixed lease payments of \$1,000,000.
- The lease contract gives LE the option to purchase the warehouse and land at a fixed price of \$10,000,000 at the end of the lease term.

Based on an analysis of the economic factors at lease commencement, LE is reasonably certain to exercise the purchase option. Therefore, the total lease payments are \$15,000,000.

- \$5,000,000 in total annual fixed payments for five years; plus
  - \$10,000,000 exercise price of the purchase option.
-

## 5.4.5 Termination penalties



### Excerpt from ASC 842-10

#### 55 Implementation Guidance and Illustrations

##### General

> Illustrations

- > Illustration of Lessee Accounting for Termination Penalties

**55-235** Example 26 illustrates how a lessee accounts for termination penalties.

- • > 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.

5.4.370 The determination of the lease term governs whether a termination penalty is included in lease payments. Termination penalties are included in the lease payments unless it is reasonably certain that the lessee will not exercise an option to terminate the lease, and therefore will not incur the penalty. [842-10-30-5(d)]

5.4.375 Question 6.7.15 addresses when and how to recognize a termination penalty paid in connection with a lease modification that only partially terminates an existing lease.



### Example 5.4.110

#### Termination penalty included in lease payments

Lessee LE leases a floor in an office building from Lessor LR for five years for monthly payments of \$20,000. The lease contract allows LE to terminate the lease after Year 3 for a lump sum payment of \$120,000. At lease commencement, it is not reasonably certain that LE will continue the lease beyond the end of Year 3.

As a result, both LE and LR include the termination penalty in the lease payments. Therefore, the total lease payments are \$840,000:

- \$720,000 for three years of fixed payments ( $\$20,000 \times 36$ ); plus
- \$120,000 termination penalty.

## 5.4.6 Residual value guarantees



### Excerpt from ASC 842-10

#### 55 Implementation Guidance and Illustrations

##### General

- > Implementation Guidance
  - > Lease Payments
    - • • > Residual Value Guarantees

**55-34** A lease provision requiring the lessee to make up a residual value deficiency that is attributable to damage, extraordinary wear and tear, or excessive usage is similar to variable lease payments in that the amount is not determinable at the commencement date. Such a provision does not constitute a lessee guarantee of the residual value.

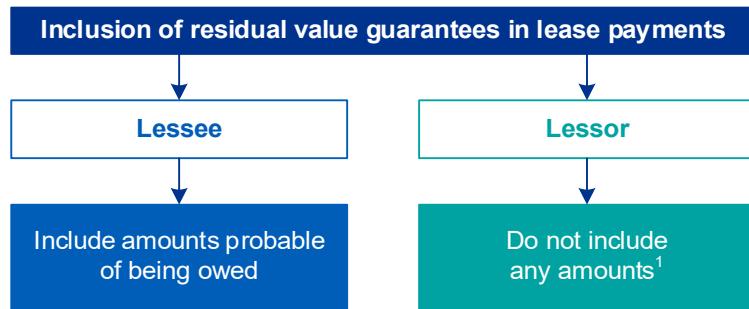
**55-35** If the lessor has the right to require the lessee to purchase the underlying asset by the end of the lease term, the stated purchase price is included in lease payments. That amount is, in effect, a guaranteed residual value that the lessee is obligated to pay on the basis of circumstances outside its control.

**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.

5.4.380 A residual value guarantee is a guarantee made to a lessor that the value of an underlying asset returned to the lessor at the end of a lease will be at least a specified amount. Residual value guarantees can be provided by the lessee or by a third party that is unrelated to the lessee or the lessor.

[842 Glossary]

5.4.390 The following chart highlights the different treatment of residual value guarantees for lessees versus lessors. [842-10-30-5(f)]



Note:

- No residual value guarantee amounts (whether provided by the lessee or by another unrelated third party) are included in the 'lease payments' by the lessor. However, the lessor's 'lease receivable' for sales-type and direct financing leases includes the full amount of any residual value guarantee(s) (see section 7.3).

5.4.400 A provision requiring the lessee to make up a residual value deficiency that is attributable to damage, extraordinary wear and tear, or excessive usage is not a residual value guarantee. Amounts related to such a provision are variable lease payments (see section 5.4.1). [842-10-55-34]

5.4.410 However, if the lessor has the right to require the lessee to purchase the underlying asset by the end of the lease term (i.e. a lessor put option), the stated purchase price is *included* in lease payments by both the lessee and lessor. Although it is not a residual value guarantee because the lessee receives the underlying asset, the amount is economically similar to a guaranteed residual value. [842-10-55-35]

5.4.420 In general, a lessee's lease payments should not be reduced for any amounts probable of being owed under a residual value guarantee that are covered by a residual value guarantee obtained from a third party by the lessee. However, an exception arises when the lessor explicitly releases the lessee from the residual value guarantee obligation, including a secondary obligation to perform if the third-party guarantor defaults. [842-10-55-36]

5.4.430 Amounts paid by a lessee for a third-party residual value guarantee are also not lease payments. They are executory costs. [842-10-55-36]

5.4.440 Residual value guarantees that are subject to the requirements of Topic 842 are not within the scope of Topic 815 (derivatives and hedging) (see section 2.2.1). [815-10-15-80]

5.4.450 When there is a change in the assessment of the amount probable of being owed under a residual value guarantee, the lessee remeasures the lease payments (see section 6.6). [842-10-35-4(c)(3)]

5.4.460 The treatment of residual value guarantees by a lessee in short-term leases is discussed in chapter 6 (see Question 6.3.30).



## Observation

**Including only amounts probable of being owed under a residual value guarantee increases judgment**

5.4.470 The Board's decision for lessees to include in lease payments only amounts probable of being owed under a residual value guarantee, rather than the entire amount of the guarantee, results in the recognition of smaller lease liabilities and ROU assets by lessees. However, the judgment that is involved in determining and reassessing amounts probable of being owed and the requirement to remeasure the lease payments whenever that assessment changes, and potentially to allocate those changes to multiple components of the contract (including non-lease components), adds complexity to the lessee accounting model for leases that include a lessee residual value guarantee.



## Question 5.4.90

### Determining probable amounts owed

**How should an entity estimate the amount probable of being owed under a residual value guarantee it provides to the lessor?**

**Interpretive response:** Topic 842 requires a lessee to estimate, and reassess, the amount probable of being owed under a residual value guarantee it provides to the lessor, but does not provide guidance about how to make this estimate. Example 5.4.120 demonstrates one way in which we believe the lessee could estimate the amount probable of being owed in a scenario of that nature.

Another approach that we believe would be acceptable is to assign probabilities to potential outcomes and to include in the lease payments the minimum amount that exceeds the 'probable' threshold.<sup>1</sup> For example, a lessee might consider there to be the following possible outcomes.

Amount lessee could owe	Probability
\$ -	20%
10	25%
20	25%
30	20%
40	10%

Under this approach, the lessee would conclude that it is probable that it will owe at least \$10 to satisfy the residual value guarantee. While it is possible that the lessee will owe \$30 or \$40, and it is more likely than not that the lessee will owe at least \$20, the probability of those outcomes is not likely to occur.

However, both Example 5.4.120 and the above are illustrative only. Because Topic 842 does not prescribe how to make the estimate, there may be a number of acceptable approaches.

Note:

1. ‘Probable’ is defined as the future event or events are likely to occur. [\[842 Glossary\]](#)



### Example 5.4.120

#### **Residual value guarantee as a component of the lessee's lease payments**

Lessee LE leases a new semi-trailer truck from Lessor LR for four years for annual payments of \$24,000. Under the contract, LE guarantees a residual value of \$60,000 to LR at the end of the lease term.

In deciding whether the lease payments include any amount related to LE’s residual value guarantee, LE observes that similar trucks are regularly sold in used condition, with detailed listings published on dealer sites. LE researches those listings and finds similar trucks around four years of age, for sale or with estimated values between \$50,000 and \$60,000.

Mileage is a key determinant in pricing different trucks of the same age. LE expects to drive the truck 120,000 miles per year, which is at the high end of the range of mileage noted in the used sale listings. Therefore, LE concludes that it is likely that the residual value of the truck will be closer to \$50,000 than \$60,000 at the end of the lease, and therefore that the probable amount that will be owed by LE at the end of the lease term will be \$10,000. Consequently, LE’s lease payments include the \$10,000.

LR includes no amounts related to the residual value guarantee in its measurement of the lease payments. However, if the lease were a sales-type or a direct financing lease, the full \$60,000 residual value guarantee would be included in determining LR’s lease receivable (see section 7.3.1).



### Example 5.4.130

#### **Lessee accounting for right to receive excess over guaranteed residual value**

Continuing Example 5.4.120, in addition to the guarantee of a residual value of \$60,000, the contract stipulates that:

- LR will sell the truck at the end of the four-year lease term; and
- if LR sells the truck for more than \$60,000, LR will pay LE any surplus above that amount.

LE accounts for the potential gain on sale of the residual asset as a contingent gain under Subtopic 450-30 (gain contingencies). Therefore, LE recognizes a gain only when the sale is completed and to the extent that the sales price exceeds \$60,000.



## Question 5.4.100

### Guarantees of lessor debt

#### Can a lessee guarantee of a lessor's debt be considered a residual value guarantee?

**Interpretive response:** In some circumstances, yes.

As a starting point, lease payments do not include a guarantee by the lessee of the lessor's debt. [842-10-30-6(b)]

However, a lessee guarantee of debt related to the underlying asset generally would be considered in substance a residual value guarantee if the debt is

- nonrecourse to the borrower – i.e. recourse is solely to the underlying asset; or
- recourse to the borrower but the borrower is a special purpose entity with no significant assets other than the underlying asset.

This is because at the end of the lease term, a payment from the lessee to the lessor's nonrecourse lender under the loan guarantee would be substantively no different from the lessee making a direct payment to the lessor under a residual value guarantee.

In this situation, a lessee should include in lease payments the amount that is probable of being owed at the end of the lease term under its guarantee of the lessor's debt. Conversely, the lessor would not account for any of this amount as lease payments. However, if the lease were a sales-type or a direct financing lease, the full amount of the guarantee would be included in determining the lessor's lease receivable.

This same thought process would apply to a lessee loan to a lessor if the balance of the loan outstanding at the end of the lease term is considered in substance a residual value guarantee, unless the lessee has recourse to substantive other assets of the lessor beyond the leased asset.

A lessee is required to recognize a liability for the fair value of a guarantee of debt related to the underlying asset under Topic 460 (guarantees) if the guarantee is not an in-substance residual value guarantee. Topic 842 does not provide guidance about where to recognize the corresponding debit. As a result, we believe any of the following could be acceptable if applied consistently:

- expense the amount at the time the liability is established;
- capitalize the amount as part of the ROU asset, in a manner similar to an initial direct cost (see section 6.3); or
- capitalize the amount as an asset separate from the ROU asset.



## Question 5.4.110

### Interaction of Topic 842 with Topic 810

#### Can lease terms create a variable interest in a variable interest entity?

**Interpretive response:** In some circumstances, yes. In general, operating leases are not variable interests in a variable interest entity (VIE) because they create rather than absorb risk. [810-10-55-39]

However, a lessee in an operating lease has a variable interest in a VIE lessor through its operating lease if it: [810-10-25-55]

- has a fixed-price purchase option; or
- makes a residual value guarantee to the lessor with respect to leased assets with a fair value in excess of 50 percent of the fair value of:
  - the assets of the lessor; or
  - the assets of a silo within the VIE lessor, if the lessor is a VIE for reasons other than the lease agreement.

For further discussion of operating leases and variable interests in a VIE, see KPMG Handbook, [Consolidation](#).



#### Comparison to legacy US GAAP

##### Full amount of residual value guarantees included in Topic 840 minimum lease payments

5.4.480 Under Topic 840, the definition of 'minimum lease payments' for a lessee included the full amount of any residual value guarantee that it provided (e.g. the \$60,000 in Example 5.4.120), rather than just the amount that is probable of being owed. This is one aspect of Topic 842 that results in a difference in the accounting for finance leases as compared to capital leases. In general, the lease liability and the ROU asset are smaller under Topic 842 for a finance lease that includes a lessee residual value guarantee than the capital lease obligation and capital lease asset were under Topic 840. [840 Glossary]

5.4.490 While the definition of minimum lease payments applicable to lessors in Topic 840 included the full amount of any residual value guarantee (provided by the lessee or any other unrelated third party) and the definition of *lease payments* included no amounts related to residual value guarantees, this has no appreciable difference on a lessor's accounting under Topic 842. This is because:

- the full amount of any residual value guarantee(s) is included in the lessor's *lease receivable* (which is a component of the lessor's net investment in the lease, together with any unguaranteed residual value and deferred selling profit for direct financing leases, if any) for sales-type and direct financing leases; and

- operating lessors' lease income under Topic 840 was calculated based on the *minimum rental payments*, which excluded guaranteed residual values, rather than the *minimum lease payments*.

## 5.5 Initial direct costs



### Excerpt from ASC 842-10

#### **30 Initial Measurement**

##### **General**

> Initial Measurement of the Lease Payments

- > 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.

#### **55 Implementation Guidance and Illustrations**

##### **General**

> Illustrations

- > Illustration of Initial Direct Costs

**55-239** 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:

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

**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).

5.5.10 Initial direct costs are incremental costs of a lease that would not have been incurred if the lease had not been obtained (i.e. not been executed).

[842 Glossary]

5.5.20 This section discusses the costs that meet the definition of initial direct costs, and the accounting is discussed in sections 6.3 – 6.4 (lessees) and 7.3 – 7.4 (lessors). The following are examples of costs that would typically be included in, or excluded from, initial direct costs. [842-10-30-9 – 30-10, ASU 2016-02, BC221–BC222, BC304]

Typical initial direct costs	
Include	Exclude
<ul style="list-style-type: none"> <li>— Commissions</li> <li>— Payments made to an existing tenant to incentivize that tenant to terminate the lease</li> </ul>	<ul style="list-style-type: none"> <li>— Legal fees</li> <li>— Costs of evaluating the prospective lessee's financial condition</li> <li>— Costs of negotiating lease terms and conditions</li> <li>— General overheads</li> </ul>



### Observation

#### Narrowed definition of 'initial direct costs' based on contract acquisition costs guidance in Topic 606

5.5.30 The Board's decisions on defining, allocating and accounting for initial direct costs were intended to align the guidance on initial direct costs by a lessor with the guidance for costs to obtain a contract by a seller of similar goods. [\[ASU 2016-02.BC306–BC307\]](#)

5.5.40 Similar to the initial direct costs guidance in Topic 842, the contract cost guidance in Subtopic 340-40 (other assets and deferred costs related to contracts with customers):

- recognizes as a contract cost asset only those incremental costs to obtain a contract that an entity incurs that would not have been incurred if that contract had not been obtained;
- allocates capitalized costs to the goods and services to which they relate, and similarly relies on judgment to make that determination; and
- amortizes contract cost assets on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the contract cost asset relates. The specific accounting for those costs that meet the definition of initial direct costs under Topic 842 is discussed in sections 6.3 – 6.4 (lessees) and 7.3 – 7.4 (lessors).

See chapter 12 of KPMG Handbook, [Revenue recognition](#).

5.5.50 The lease payments might be an allocated amount when there are multiple lease components, or when there is at least one non-lease component (see paragraph 5.4.40). This might also be the case with initial direct costs – e.g. in a contract in which a commission is paid for the lease and the non-lease component. Judgment is involved in determining whether costs, such as a commission paid to a broker, relate to a lease component, a non-lease component or both. Examples 5.5.20 and 5.5.30 illustrate how this allocation may work under Topic 842. [\[ASU 2016-02.BC222, BC306\]](#)



### Question 5.5.10

#### **Payments to existing lessee to induce early termination**

#### **Are payments made by a lessor to a lessee to induce early termination of the lease agreement an initial direct cost?**

**Interpretive response:** In certain situations, yes. A payment to induce early termination is an example of a potential initial direct cost. However, initial direct costs are only those that are incurred as a result of obtaining a lease. [842-10-30-9]

Therefore, in general, we believe these payments are initial direct costs if incurred in connection with a replacement lease. For example, to obtain a lease with a new lessee that has been identified, the lessor may need the existing lessee to terminate its lease of the underlying asset; in that case, we believe the payment to the existing lessee is an initial direct cost of obtaining the new lease.

In contrast, if a lessor offers to make a payment to a lessee to early terminate a lease solely because the current lease is at a below-market rate (i.e. the lessor wants to terminate an out-of-the-money lease) and does not have an identified new lessee, the payment would generally not meet the definition of an initial direct cost.



### Question 5.5.20

#### **'Key money' payments**

#### **How should a new lessee account for 'key money' payments paid to an existing lessee?**

**Background:** The term 'key money payment' is often used to describe a situation in which a new lessee makes a payment to an existing lessee for the right to assume the existing lessee's lease.

The new lessee makes a payment to the existing lessee to essentially buy the original lessee's rights under the lease. The lessor is required to extend the original terms of the lease, which are generally favorable, to the new lessee, which is why the new lessee is willing to pay the existing lessee for the right to assume the lease.

**Interpretive response:** Many lessees account for key money payments as intangible assets in the scope of Topic 350 (goodwill and other intangibles). Others account for these payments as initial direct costs. We believe either accounting approach is acceptable as an accounting policy election, which should be applied consistently.

#### **Intangible asset**

Amounts paid directly to an existing lessee are separate from the lease agreement negotiated with the landlord, and the accounting for such amounts

is separate from the lessee's lease accounting. Because it arises from contractual and/or other legal rights, key money paid to existing tenants qualifies to be recognized as an intangible asset. [350-30-25-4, 805-20-25-10]

In general, the intangible asset will have a useful life equal to the lease term plus applicable option periods (not to exceed the economic life of the leased premises), provided that there are no legal, regulatory, contractual or other provisions limiting the useful life to a shorter period. [350-30-35-3(c)]

Amortization of the intangible asset should be over its useful life to its residual value. Because market conditions dictate the residual value, an entity should periodically reassess its residual value estimate and, if necessary, prospectively adjust future amortization.

The SEC staff has previously not objected to these accounting conclusions. Because Topic 350 was not amended with the issuance of Topic 842, we believe the SEC staff's views remain relevant.

#### **Initial direct cost**

If a lessee accounts for key money payments as an initial direct cost, they are accounted for in the same manner as any other initial direct costs. This means that the payments are capitalized as part of the cost of the ROU asset, which will be amortized to zero by the end of the lease term (see sections 6.3 and 6.4). Therefore, the amortization period of the key money payment will not extend beyond the lease term.

#### **Changing accounting policy**

Topic 250 (accounting changes and error corrections) applies if a lessee elects to change its accounting policy for key money payments on or after adoption of Topic 842.



#### Question 5.5.30

##### **Sales taxes as initial direct costs**

#### **Are sales or other similar taxes ever initial direct costs?**

**Interpretive response:** No. This is regardless of whether (1) the entity is the lessee or the lessor, (2) the sales or other similar tax is a lessee cost or a lessor cost, and (3) the tax is incurred over the lease term or at or before lease commencement.

- Sales and other similar taxes do not meet the definition of an initial direct cost when they are incurred over the lease term (e.g. assessed on, and as a percentage of, each lease payment) because they are not incurred solely as a result of entering into the lease.
- Sales and other similar taxes do not meet the definition of an initial direct cost even when incurred at or before lease commencement because they are not incurred solely as a result of entering into the lease. Rather, whether and how much sales tax is incurred depends, for example, on decisions about where the underlying asset will be located/operated.

Even though sales and other similar taxes do not meet the definition of an initial direct cost, such taxes incurred at or before lease commencement may be accounted for in substantially the same manner as an initial direct cost.

- A lessee that has elected an accounting policy to capitalize costs incurred to prepare the ROU asset for its intended use (see Question 5.1.10) will capitalize the tax as part of the cost of the related ROU asset by analogy to Topic 360 (property, plant and equipment). In such case, like an initial direct cost, the cost of the tax will be amortized to expense over the lease term.
- Sales or other similar taxes incurred by lessors that are not manufacturers or dealers in sales-type or direct financing leases will be included in the lessor's net investment in the lease (see section 7.3.1). Consequently, the accounting for those tax costs will be substantially the same as if they were an initial direct cost (which is also included in the net investment in the lease – see paragraph 7.3.35).

Operating lessors will not account for sales or other similar taxes incurred at or before lease commencement like initial direct costs, but also will not expense the taxes when incurred. Generally, the tax will become part of the cost basis of the underlying asset, and therefore recognized to expense over the asset's useful life.

Question 4.2.60 discusses lessee and lessor accounting for sales and other similar taxes in more detail.

### Question 5.5.40

#### Third-party payments to a lessee for executing a lease

#### How does a lessee account for payments it receives from a third party for executing the lease?

**Background:** A lessee may be entitled to a payment from an unrelated third party once a lease contract is executed. For example, the lessee may be entitled to a portion of the commission a broker receives from the lessor.

**Interpretive response:** If other US GAAP applies to the payment, that guidance should be followed to account for the payment. For example, Topic 606 (revenue from contracts with customers) applies if the payment is for the lessee's satisfaction of a performance obligation.

However, if no other US GAAP applies, we believe it is appropriate for the lessee to treat the payment as a reduction in the carrying amount of the ROU asset, akin to a *negative* initial direct cost, reducing the cost of the lease over the lease term. If the payment would reduce the carrying amount of the ROU asset below zero, we believe the excess should be accounted for in the same manner as a lease incentive that would result in a negative ROU asset (see Question 6.3.15).



### Example 5.5.10

#### Costs that are initial direct costs

Lessee LE and Lessor LR enter into a lease. The following are costs that they incur in connection with the lease.

Cost	Incurred by:	
	LE	LR
Allocation of employee costs to negotiate lease terms and conditions	\$ 5,000	\$10,000
External legal fees	12,000	20,000
Travel costs related to inspecting the underlying asset	4,000	-
Commission to tenant's agent (LE) / listing agent (LR)	20,000	30,000
Payment made to existing tenant to terminate the lease	-	20,000

LE has initial direct costs of \$20,000 in connection with this lease that it includes in the initial measurement of the ROU asset for the lease.

- The \$20,000 commission to the tenant's agent is an initial direct cost because it is only incurred upon obtaining the lease – i.e. it would not have been owed if the lease had not been executed.
- None of the other costs incurred by LE are initial direct costs, because they would have been incurred even if the lease had not been obtained. For example, employee salaries are paid regardless of whether the lease is obtained; therefore, the allocation of employee costs is not an initial direct cost. In addition, LE would be required to pay its attorneys for negotiating and drafting the lease even if the lease was not executed.

LR has initial direct costs of \$50,000.

- The \$30,000 listing agent commission is an initial direct cost for the same reason as it was for LE. In addition, the payment to the existing tenant of \$20,000 to terminate the existing lease is an initial direct cost because it is paid only as a consequence of executing the new lease.
- None of the other costs incurred by LR meet the definition of initial direct costs, because they would have been incurred even if the lease had not been executed. The allocation of employee costs and the external legal fees are not initial direct costs to LR for the same reasons that they were not initial direct costs to LE.



### Example 5.5.20

#### Allocation of initial direct costs (1)

Continuing Example 5.4.10, Lessor LR's standard practice is to pay a commission to its salesperson on the total value of the contract obtained. Therefore, LR concludes that the commission of \$25 relates to both the lease

and the maintenance services, and allocates the commission on the same basis as the consideration in the contract.

Component	Allocation	Calculation
Lease (equipment)	\$20	$25 \times 80\%$
Non-lease (maintenance)	5	$25 \times 20\%$
	<b>\$25</b>	

Therefore, LR has initial direct costs of \$20. The \$5 allocated to the maintenance services is accounted for in accordance with the incremental costs to obtain a contract guidance in Subtopic 340-40 (see chapter 12 of KPMG Handbook, [Revenue recognition](#)).



### Example 5.5.30

#### Allocation of initial direct costs (2)

Lessee LE and Lessor LR enter into a five-year lease of retail space in a shopping center. In addition to providing a right to use the retail space, LR will provide common area maintenance (CAM). As a result, there are two components of the contract: a lease component comprising the right to use the retail space, and a non-lease component comprising CAM.

Annual rent payments are fixed at \$1,000, while charges for CAM will be billed on a proportionate basis to all tenants of the shopping center on a monthly basis.

Both LE and LR pay a broker commission of \$250, which equals five percent of the fixed rent payments in the contract. This percentage is the standard commission paid in this market for real estate leases, regardless of whether the lease is a gross lease or a net lease (see section 4.2), and regardless of whether the lease includes non-lease components like CAM.

Consequently, both LE and LR conclude that the commission relates solely to the lease component of the contract. The commission was incurred only as a direct result of the lease being executed; therefore, the commission is an initial direct cost to both LE and LR.



#### Comparison to legacy US GAAP

##### Fewer costs of lease origination are initial direct costs under Topic 842

5.5.60 An entity's initial direct costs for a lease are substantially less for many leases under Topic 842 than they were under Topic 840. This is because Topic 842 defines initial direct costs as only those incremental costs of a lease that would not have been incurred if the lease had not been obtained (i.e. not executed), while initial direct costs under Topic 840 also included the following.

- Other incremental costs that were incurred directly as a result of the lease, even if such costs were incurred to negotiate and arrange the lease, and

therefore would have been incurred even if the lease was not executed (e.g. external legal fees).

- A lessor's incurred costs, even if not incremental to the lease, directly related to fulfilling specified activities to negotiate or arrange the lease. Those specified activities were:
  - evaluating the prospective lessee's financial condition;
  - evaluating and recording guarantees, collateral and other security arrangements;
  - negotiating lease terms;
  - preparing and processing lease documents; and
  - closing the transaction.

The costs directly related to those activities included only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that lease and other costs related to those activities that would not have been incurred but for the lease. [840-20-25-17 – 25-19]

5.5.70 Because of the narrowed definition of initial direct costs, many entities will recognize significant origination costs for a lease as incurred that they did not recognize as incurred under Topic 840. Lessors in that situation will recognize greater margins on their lease income earned over the lease term (e.g. operating lease income or interest income on their direct financing leases) as compared to Topic 840, while lessees will recognize less lease expense during the lease term as compared to Topic 840.

5.5.80 The narrowed definition of initial direct costs in Topic 842 that does not include allocated internal costs may be simpler to apply than the definition in Topic 840 because entities no longer need to have processes and controls to track employee time spent on negotiating and arranging leases.

## 5.6 Discount rate for the lease



### Excerpt from ASC 842-10

#### 20 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.

### 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.



### Excerpt from ASC 842-20

#### 30 Initial Measurement

##### General

> Discount Rate for the Lease

**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 instead of its incremental borrowing rate, determined using a period comparable with that of the **lease term**, as an accounting policy election made by class of underlying asset.

**30-4** See Example 2 (paragraphs 842-20-55-17 through 55-20) for an illustration of the requirements on the discount rate.

5.6.10 For a *lessee*, the discount rate for the lease is the rate implicit in the lease unless that rate cannot be readily determined. In that case, the lessee is required to use its incremental borrowing rate. For a lessor, the discount rate for the lease is the rate implicit in the lease. [842 Glossary, 842-10-25-4, 842-20-30-3, 842-30-30-1]

5.6.20 The discount rate for the lease is determined based on information available at lease commencement. [842-20-30-2]

5.6.30 When the rate implicit in the lease is not readily determinable (see Question 5.6.20), a lessee that is not a public business entity is permitted to use a risk-free discount rate for the lease, instead of its incremental borrowing rate, as an accounting policy election by class of underlying asset. The risk-free rate is determined using a period comparable to that of the lease term. See Question 4.4.17 for changes to the election of a practical expedient, including the risk-free discount rate practical expedient. [842-20-30-3]



### Question 5.6.05

#### **Use of a risk-free discount rate by certain public business entities**

**Is a lessee that is a 'public business entity' solely because its financial statements or summarized financial information are included in a registrant's SEC filing permitted to use a risk-free discount rate for its leases?**

**Background:** An entity may qualify as a public business entity (PBE) solely because its financial statements or summarized financial information is included in a registrant's SEC filing (i.e. under Rule 3-05, Rule 3-09 or Rule 4-08(g)). An entity that meets this definition of a PBE may adopt Topic 842 using the effective dates for 'other entities'; see Question 13A.1.50 or Question 13B.1.50. [\[842 Glossary, 842-10-S65-1\]](#)

Because of this effective date relief, the question arose about whether that same entity is also permitted to use a risk-free discount rate for its leases as described in paragraph 5.6.30.

**Interpretive response:** No. The SEC staff has stated that it would not be acceptable for PBEs, including those that are the subject of this question, to discount their leases using the risk-free discount rate option available to entities that are not PBEs. This includes leases that may have commenced before the lessee became a PBE. [\[CAQ SEC Regs Comm 10/2020\]](#)



### Question 5.6.06

#### **Use of risk-free discount rate during an IPO**

**Can a private entity continue to use a risk-free discount rate for its leases while undergoing an IPO?**

**Interpretive response:** No. When a private entity becomes a public company, it must follow accounting standards and financial reporting guidelines for public companies established by the FASB and the SEC. During an IPO process, a private entity follows the accounting standards that apply to public business entities (PBEs) and the rules and regulations of the SEC. The entity converts its financial statements to the extent its financial statements as a private entity did not reflect these requirements. This includes unwinding any private company accounting alternatives that were previously elected.

Therefore, if an entity had previously elected the risk-free discount rate practical expedient (see paragraph 5.6.30), it is required to recalculate and recast all previous leases as if it had always applied the discount rate guidance applicable to PBEs. For example, if an entity had determined the discount rate for a lease that commenced two years prior using a 2% risk-free discount rate, it must reassess what its incremental borrowing rate would have been at the

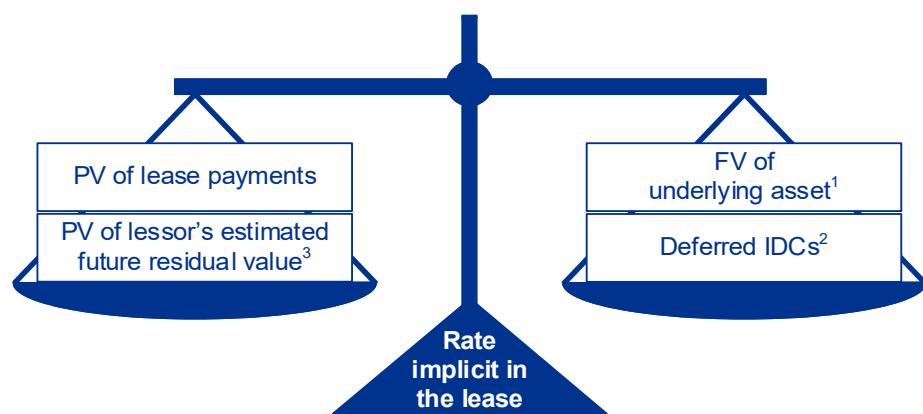
commencement date (e.g. 8%) and retrospectively account for the lease as if that had always been the discount rate for the lease.

This is required even if the entity is an emerging growth company (EGC).

Because of this, a private entity that may become, or is contemplating becoming, a public company should carefully consider the steps and processes needed to unwind and convert its financial statements before electing the risk-free rate practical expedient.

## 5.6.1 Rate implicit in the lease

5.6.40 The rate implicit in the lease is the rate of interest that, at a given date, causes the aggregate present value of (a) the lease payments, and (b) the amount that a lessor expects to derive from the underlying asset following the end of the lease term *to equal* the sum of (1) the fair value of the underlying asset minus any related investment tax credit retained and expected to be realized by the lessor, and (2) any deferred initial direct costs of the lessor. However, if the rate determined in accordance with this equation is less than zero, a rate of zero should be used. The rate implicit in the lease cannot be less than zero. [842 Glossary]



Notes:

1. For purposes of determining the rate implicit in the lease, the fair value of the underlying asset is reduced by the amount of any investment tax credit related to the underlying asset that is retained and expected to be realized by the lessor. [842 Glossary]
2. Initial direct costs are not deferred (i.e. they are expensed at lease commencement) if the lease is a sales-type lease and the fair value of the underlying asset differs from its carrying amount at lease commencement (see section 7.3.1). [842-30-25-1(c)]
3. If a lessee uses the rate implicit in the lease, the estimated future residual value excludes amounts probable of being owed by the lessee to satisfy a residual value guarantee, which are included in the lease payments (see section 5.4.6).

5.6.50 A lessor may be required to use three different discount rates to account for a lease.

- For purposes of assessing whether a lease is a sales-type lease (i.e. in measuring the present value of the lease payments and residual values

guaranteed by the lessee), a lessor uses a rate implicit in the lease that *assumes* no initial direct costs will be deferred if, at lease commencement, the fair value of the underlying asset is different from its carrying amount. [842-10-25-4]

**Note:** The lessor uses a rate implicit in the lease that includes any initial direct costs of the lessor if the fair value of the underlying asset equals its carrying amount.

- Then, if the lease is not a sales-type lease, to assess whether the lease is a direct financing lease or an operating lease, the lessor uses a rate implicit in the lease that includes its initial direct costs regardless of whether the fair value of the underlying asset is different from its carrying amount.
- A third discount rate may be used if the lease is a direct financing lease that gives rise to selling profit. In that case, the selling profit is deferred at lease commencement as a reduction of the net investment in the lease (see paragraph 7.3.30). The lessor then uses a rate that would have resulted, at lease commencement, in the sum of (1) the lease receivable and (2) the unguaranteed residual asset equaling (a) the fair value of the underlying asset, less (b) the selling profit in determining how to accrete the net investment in the lease (see Example 7.3.40).

5.6.60 The rate ultimately used in determining lease classification is then used to initially measure the lessor's lease receivable and unguaranteed residual asset if the lease is a sales-type or direct financing lease (see section 7.3.1). [842-30-30-1]



### Example 5.6.10

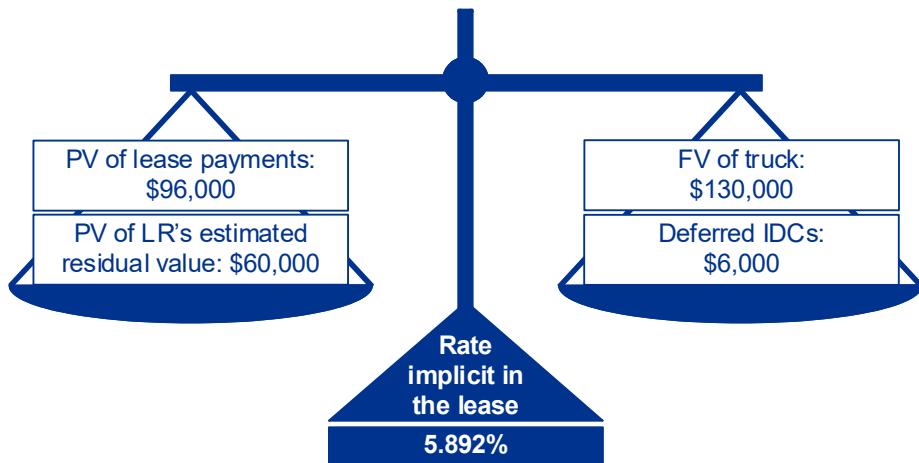
#### Lessor determination of the rate implicit in the lease

Lessee LE leases a new truck from Lessor LR for four years.

The following facts are relevant.

- Under the contract, LE pays \$24,000 per year, payable annually in advance.
- LR estimates that the residual value of the truck will be \$60,000 at the end of the four-year lease term.
- The lease contains no transfer of ownership provisions, no lessee purchase option, no residual value guarantees and no renewal options.
- There are no non-lease components (e.g. maintenance services) in the contract.
- LR incurs \$6,000 in initial direct costs associated with executing the lease. These costs will be deferred because LR's purchase price to acquire the truck at lease commencement (i.e. its carrying amount) equals its fair value (\$130,000) (see section 7.3).
- LR will not retain any investment tax credit associated with the truck (see paragraph 5.6.40).

The rate implicit in the lease is the rate that balances the following equation, which is 5.892%:



#### Question 5.6.10

#### **Significant variable lease payments that result in negative implicit rate**

#### **How is the rate implicit in the lease determined when the lease includes significant variable lease payments?**

**Interpretive response:** For leases with significant variable lease payments (e.g. in some renewable energy and other arrangements – see Question 7.3.30), the undiscounted sum of (1) the lease payments and (2) the estimated residual value of the underlying asset at the end of the lease term may be less than the underlying asset's fair value and/or carrying amount at lease commencement. As discussed in section 5.4.1, this is because variable lease payments that do not depend on an index or a rate are excluded from the lease payments.

In the event that the rate implicit in the lease would be negative in these variable lease payments scenarios if applying the calculation in the first sentence of the definition of 'rate implicit in the lease', an implicit rate of zero should be used. [\[842 Glossary\]](#)

A lessor should not, in such cases, use another discount rate for the lease such as the lessee's incremental borrowing rate or a rate that estimates the variable payments.

5.6.70 [Not used]



### Question 5.6.20

#### **Lessee use of the rate implicit in the lease – readily determinable**

#### **Will the rate implicit in the lease be readily determinable for a lessee?**

**Interpretive response:** In all but rare cases, no. This is because the rate implicit in the lease is an internal measure, specific to the lessor. To determine this rate, the lessee must know both (1) the *lessor's* estimate of the residual value of the underlying asset (consistent with Topic 840) and (2) the amount of 'initial direct costs' that the lessor will defer for the lease (see section 5.5).

The lessor's estimate of the residual value of the underlying asset will typically not be readily determinable because it is based on the *lessor's* specific expectations about the future. However, it may be determinable for some finance leases if the lease includes a provision to convey the asset to the lessee at the end of the lease term through an automatic transfer of title or a bargain purchase option. In that case, the lessor's estimated residual value would be zero.

The capitalizable initial direct costs incurred by the lessor will generally not be known by the lessee because the costs incurred will be to a third party (e.g. a broker) unrelated to the lessee. However, it is possible the lessee may be able to conclude that any reasonable estimate of those costs would not affect the implicit rate.

It is also possible that in some cases, the lessee would be able to obtain relevant information about the lessor's estimated residual value and/or capitalizable initial direct costs directly from the lessor. However, such cases are likely to be rare given the sensitivity of that information to the lessor. Even if the lessor does provide relevant information, the lessee must assess whether this information is reliable and sufficient to determine the rate implicit in the lease.

Because lessees generally do not have access to both such pieces of information, the rate implicit in the lease will not be readily determinable and they will use their incremental borrowing rate for nearly all leases.



### Question 5.6.25

#### **Lessee use of the rate implicit in the lease when it is zero for the lessor**

#### **Must a lessee use the rate implicit in the lease when it is clear that rate is zero?**

**Background:** If the rate implicit in the lease would be negative based on applying the calculation in the first sentence of the definition of 'rate implicit in the lease', a rate of zero is used (see Question 5.6.10). [842 Glossary]

In situations where the calculation would clearly result in a negative implicit rate (see Question 5.6.10 and Example 7.3.30), the question arises as to whether the rate implicit in the lease is *readily determinable* to the lessee and therefore must be used by the lessee as the discount rate for the lease.

For example, consider a ten-year lease of equipment with a 15-year economic life. The lease payments are predominantly variable such that the lessor's estimated residual value of the underlying asset at the end of the lease term needs to be most (or all) of the lease commencement date fair value of the underlying asset for the rate implicit in the lease to be positive. It is clear that the lessor's estimated residual value of the equipment two-thirds of the way through the asset's economic life would be a relatively minor portion of the asset's commencement date fair value.

**Interpretive response:** We are aware of different views in relation to this question. In the absence of further guidance from the FASB or the SEC staff, we believe that either of the views below is acceptable as an accounting policy election.

As a practical matter, the response to this question may not have a significant effect on the lessee's accounting. This may be because *all* of the payments in the contract are variable, or because the effect of the difference between the implicit rate and the lessee's incremental borrowing rate is insignificant – e.g. because the fixed component of the contractual payments is small. However, the effect may not always be insignificant.

#### **View 1: Yes, the implicit rate is readily determinable at zero and therefore must be used**

Using the background example, it is clear to the lessee that any realistic lessor estimate of residual value would result in a negative calculated implicit rate. Therefore, the lessor is required to use an implicit rate of zero.

Under this view, it is not important for the lessee to have the lessor's actual inputs (see Question 5.6.20) to the implicit rate calculation. It matters only that the rate is readily determinable because any *realistic* lessor estimate of residual value or deferred initial direct costs could not result in an implicit rate other than zero.

#### **View 2: No, the implicit rate is still generally not readily determinable**

Under this view, the last sentence of the 'rate implicit in the lease' definition is interpreted differently from View 1. That sentence states, "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." [Emphasis added] [\[842 Glossary\]](#)

In contrast to View 1, it is not enough for it to be clear that the calculated rate would be negative. The lessee must be able to readily determine the actual negative rate that would result from the calculated formula in the definition (see Question 5.6.20) to determine that an implicit rate of zero must be used.

This view also considers that ASU 2018-10, which amended the definition of 'rate implicit in the lease' to create the implicit rate 'floor' of zero, and the FASB's public deliberations of the issue leading to this amendment, discussed the amendment solely in the context of lessors. Therefore, the FASB did not intend for the implicit rate 'floor' of zero to affect a lessee's accounting.

## 5.6.2

### Lessee's incremental borrowing rate

5.6.80 The incremental borrowing rate is the rate of interest that a lessee would have to pay to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment. [842 Glossary]



#### Example 5.6.20

##### Lessee determination of incremental borrowing rate (1)

Assume the same facts as Example 5.6.10, except that LE:

- does not have readily available information to determine LR's estimated residual value of the truck; or
- has readily available information to determine LR's estimated residual value, but does not know LR's deferred initial direct costs.

Without both pieces of information, LE cannot determine the rate implicit in the lease. Therefore, LE uses its incremental borrowing rate as the discount rate for the lease.

In determining the incremental borrowing rate, LE considers the rate of interest that it would have to pay on a collateralized borrowing in an amount equal to the lease payments (\$96,000) under similar terms (e.g. over three years).<sup>1</sup>

LE also considers that it has an unsecured line of credit with a fixed rate of 7% as well as an eight-year term loan with the same national bank, secured by the assets of the company, with an original balance of \$10 million and a fixed interest rate of 4%. LE determines the most efficient way for it to arrive at a reasonable incremental borrowing rate is to request its bank to quote a rate for a three-year loan of \$96,000, secured by a commercial vehicle similar to the truck in the lease, to be repaid over the three years. LE reviews the quote, which is 5.5%, for reasonableness based on the current risk-free rate and its credit history, and determines that the rate is reasonable. Therefore, LE uses a 5.5% discount rate to calculate the present value of the lease payments.

Note:

1. LE is paying the annual payments in advance so will have made its final payment at the beginning of Year 4 of the lease, not at the end.



#### Question 5.6.30

##### Lessor vs. lessee discount rates

### Will lessors and lessees use the same discount rate for a given lease?

**Interpretive response:** In general, no. This is because, absent rare circumstances, the rate implicit in the lease used by the lessor and the lessee's incremental borrowing rate used by the lessee will be different rates.



### Question 5.6.35 Lessee credit rating

#### Can a lessee with a good credit rating assume that its incremental borrowing rate is the same for all leases?

**Interpretive response:** No. The definition of incremental borrowing rate indicates that it is a rate specific to the lessee, equivalent to what the lessee would have to pay to borrow the 'lease payments' on a collateralized basis.

Credit rating is only one of many factors that lenders consider when determining how much and at what rate to lend funds to an entity. Generally, interest rates are inversely related to an entity's credit rating – i.e. the higher the credit rating, the lower the interest rate as it is less likely that a borrower (or lessee) with a high credit rating will default on a payment.

Many factors affect an entity's credit rating, such as:

- borrowing and payment history;
- length of credit history;
- evidence of default;
- current ability to repay debts; and
- future economic outlook.

Therefore, an entity's credit rating is subject to change over time and may not be the same at the commencement date of each of its leases.



### Question 5.6.40 Determining the discount rate for a portfolio of leases

#### Can an entity determine a discount rate for a portfolio of leases?

**Interpretive response:** In some circumstances, yes. As discussed in section 5.8, the Board concluded that the leases guidance in Topic 842 can be applied at a portfolio level by lessees and lessors in some circumstances, rather than on a lease-by-lease basis.

The Basis for Conclusions to ASU 2016-02 and Example 2 in Subtopic 842-20 highlight that the Board expects that some lessees will be able to use a portfolio approach to determine the discount rate for their leases with similar characteristics. This is permitted if doing so would not materially affect the lessees' accounting for those leases to which a single discount rate is applied. In the Board's view, applying a portfolio approach to determine the discount rate alleviates some of the concerns that entities expressed about determining (and documenting the basis for) a separate incremental borrowing rate for every lease. [842-20-55-18 – 55-20, ASU 2016-02.BC201]

From a practical standpoint, an entity may be able to document which discount rate to apply for certain portfolios of leases, considering characteristics such as lease term, lease currency and geographic location. It could then apply a discount rate to a portfolio of leases with similar characteristics. The entity would need to design controls around portfolio discount rates to ensure that such rates are applied only to leases with similar characteristics and that the rates are updated periodically based on changes in the interest rate environment and other relevant factors.



### Question 5.6.50

#### **Subsidiary's use of parent (or group) incremental borrowing rate**

#### **In determining the discount rate for the lease, can a subsidiary use the incremental borrowing rate of its parent?**

**Interpretive response:** In some cases, yes. It might be acceptable for a subsidiary that is the lessee in a lease to use the incremental borrowing rate of its parent (or consolidated group) as the discount rate for a lease. The basis for conclusions to ASU 2016-02 states this might be appropriate when the subsidiary does not have its own treasury function (i.e. all funding for the group is managed centrally by the parent entity) and the negotiations with the lessor result in the parent entity providing a guarantee of the lease payments to the lessor. In that case, the pricing of the lease is more significantly influenced by the credit standing of the parent than that of the subsidiary. [\[IASU 2016-02.BC201\]](#)

However, we do not believe the parent must guarantee the lease payments for the subsidiary to use the parent (or group) incremental borrowing rate.

Example 2 in Subtopic 842-20 concludes that the subsidiaries in the example should use the parent's incremental borrowing rate because the treasury functions of the group are conducted centrally (i.e. by the parent, rather than by each subsidiary) such that the pricing of the lease was influenced by the group's credit standing and profile, rather than that of the subsidiaries entering into the leases. [\[842-20-55-18 – 55-20\]](#)

Given the guidance in Topic 842 and the associated basis for conclusions to ASU 2016-02 taken as a whole, we believe Topic 842 establishes a principle that use of the parent (or group) incremental borrowing rate is appropriate if the credit standing and profile of the parent (or group) more significantly affect the pricing of the lease than the credit standing and profile of the subsidiary entering into the lease.



### Question 5.6.51

#### **Adjustments to parent (or group) incremental borrowing rate**

**Can a subsidiary ignore adjustments it would otherwise make in determining its incremental borrowing rate if using a parent (or group) incremental borrowing rate?**

**Background:** Consider a scenario in which a subsidiary enters into a lease in Brazil and the parent guarantees the lease payments. The parent has recently commenced similar leases (e.g. same type of underlying asset, similar lease term) in the US and in Europe, but not in Brazil.

Consistent with Question 5.6.50, the subsidiary concludes that it is appropriate to use the parent's incremental borrowing rate (IBR) when determining the discount rate for its Brazilian lease. The question arises as to whether the subsidiary can use the parent's IBR determined for its recently commenced, similar US or European leases without adjustment for the different currency of the lease and the different economic environment (Brazil compared to the US or applicable countries in Europe).

**Interpretive response:** No. If a parent (or group) IBR is based on a lease that differs from the subsidiary lease in question (e.g. with respect to currency, economic environment, payment structure or lease term), the subsidiary must adjust the parent (or group) IBR just as it would if using a reference rate based on a borrowing that differs from the lease. Question 5.6.67 provides example adjustments to consider when a lessee estimates its IBR from a starting point of its existing unsecured borrowings. The same types of adjustments may apply when a subsidiary starts from a parent's (or group's) IBR.

In the background example, while the parent (group) IBR for recent, similar leases may be a valid starting point for determining the IBR for the subsidiary's Brazilian lease, the subsidiary should adjust that rate for the effects of foreign currency and the different economic environment (Brazil compared to the US or applicable countries in Europe) as described in Question 5.6.67.



### Question 5.6.55

#### **Incremental borrowing rate for a lease denominated in a foreign currency**

**How should a lessee determine its incremental borrowing rate for a lease denominated in a currency that is different from its functional currency?**

**Background:** In some cases, a lease contract may be denominated in a currency that is different from the company's functional currency – i.e. the currency of the primary economic environment in which the entity operates. For example, a company could have an equipment lease denominated in Japanese Yen, but a functional currency of the US Dollar.

**Interpretive response:** The lessee should use a rate at which it would borrow in the same currency as that in which the lease is denominated. Therefore, in the background example, the entity would consider the secured borrowing rate it could obtain to borrow an amount of Yen equal to the Yen-denominated lease payments over the lease term (see Example 5.6.30).



### Question 5.6.60

#### 'Cost of money' as a potential discount rate

**Can an entity use its 'cost-of-money' rate as the discount rate for the lease?**

**Interpretive response:** No. The cost-of-money rate used to reimburse entities that are required to comply with the Cost Accounting Standards and the Federal Acquisition Regulation is not an appropriate proxy for the discount rate for the lease. This is because it is not necessarily linked to the lessor's implicit rate or to the lessee's incremental borrowing rate. [ASU 2016-02.BC202]



### Question 5.6.65

#### Secured and unsecured funding sources to determine the incremental borrowing rate

**Should a lessee consider secured and unsecured borrowings when determining its incremental borrowing rate?**

**Background:** Under Topic 840, a lessee's incremental borrowing rate was the rate the lessee would have incurred to borrow over a similar term the funds necessary to purchase the leased asset. Topic 840 did not require use of a secured rate; rather, it allowed lessees to consider both secured and unsecured funding sources when determining their incremental borrowing rate.

Under Topic 840, lessees may have used a weighted-average rate that considered secured and unsecured funding sources when they concluded that secured funding would be limited by a loan-to-value ratio of less than 100 percent.

**Interpretive response:** No. Topic 842 requires the use of a secured rate – i.e. the definition of 'incremental borrowing rate' states explicitly that the rate should assume borrowing the lease payments 'on a collateralized basis'. This means that the lessee should assume its borrowing of the 'lease payments' is 100 percent collateralized (i.e. secured). Therefore, unsecured funding sources should not be used to determine the incremental borrowing rate without adjusting for the effect of collateral (see Question 5.6.66). [842 Glossary]

Question 5.6.67A discusses whether an over-collateralized reference rate must be adjusted for the effect of over-collateralization.

Topic 842 does not specify what collateral may be considered when evaluating what a collateralized borrowing rate would be; therefore, the collateral is not limited to the underlying asset. For further discussion about collateral when estimating the incremental borrowing rate, see Question 5.6.65A.



### Question 5.6.65A

#### **Collateral to use in estimating incremental borrowing rate**

#### **What should a lessee assume as collateral when estimating its incremental borrowing rate?**

**Interpretive response:** In general, we believe it is acceptable to assume the collateral to the lease is the underlying asset. This is because the FASB's basis for requiring a fully collateralized discount rate was that the lessor generally has recourse to the underlying asset – i.e. it has the right to repossess the underlying asset in the event of lessee non-payment.

However, Topic 842 does not specify what collateral may be considered when evaluating what a collateralized incremental borrowing rate would be; therefore, as affirmed in discussions with the FASB staff, we believe the assumed collateral is not limited to the underlying asset. In general, any form of collateral available to the lessee and that would be expected to be acceptable to a lender in lieu of the underlying asset (e.g. because it is expected to have similar or greater liquidity than the underlying asset) can be considered.

As discussed in Question 5.6.67 (see 'Effect of collateral'), the quality of the assumed collateral may affect the incremental borrowing rate. That is, the higher the quality of the assumed collateral, the lower the incremental borrowing rate is likely to be.



### Question 5.6.66

#### **Lessee borrows only on an unsecured basis**

#### **Can unsecured funding sources be used as an input to estimate the lessee's incremental borrowing rate?**

**Interpretive response:** Yes. As discussed in Question 5.6.65, a lessee's incremental borrowing rate must assume that the borrowing of the 'lease payments' is 100% collateralized. However, if the lessee does not have secured (i.e. collateralized) borrowings, it may use its unsecured (i.e. non-collateralized) borrowings as an *input* to derive an appropriate incremental borrowing rate.

For example, the full recourse rate that a lessee is charged on unsecured borrowings may serve as the starting point for determining the lessee's incremental borrowing rate. However, the rate indicated by those unsecured

borrowings should be adjusted for the effect of designating collateral (security) for the lease.

When the starting point for the incremental borrowing rate determination is an unsecured rate, the adjustment for the effect of designating collateral to the lease 'borrowing' should result in a lower rate than the unsecured starting point.



### Question 5.6.67

#### Adjustments to reach an appropriate incremental borrowing rate

### What adjustments might a lessee need to make when estimating its incremental borrowing rate if it starts with its existing unsecured borrowings?

**Background:** As outlined in Question 5.6.66, a lessee that does not have secured (i.e. collateralized) borrowings may use its unsecured (non-collateralized) borrowings as an input to derive an appropriate incremental borrowing rate (IBR). For example, the rate a lessee is charged on one or more relevant unsecured borrowings may serve as a starting point for estimating the IBR. However, an existing borrowing may not be relevant – i.e. may not provide information relevant to estimating the IBR for a lease. For example, a borrowing with a term vastly different from the lease term may not provide a logical starting point for estimating the IBR for the lease.

**Interpretive response:** From the starting point of an unsecured borrowing (reference borrowing), the lessee should adjust for differences between the reference borrowing and the lease, assuming they have a material effect on the IBR.

Necessary adjustments may include all of the following (not exhaustive). It is possible that a lessee will not need to make all of these adjustments to achieve a materially appropriate IBR, even if each item is a difference between the reference borrowing and the lease.

- **Effect of collateral.** In general, adding collateral (or security) to an unsecured borrowing rate will decrease the IBR being estimated for the lease, because it reduces the risk to the lender (i.e. the lessor). The effect of the adjustment may be affected by the quality of the lessee's collateral.
- **Payment structure.** The payment structure of the reference borrowing may differ from that of the lease. For example, a reference borrowing may require interest-only payments until maturity (when all of the principal must be repaid), while the lease payments repay principal throughout the lease term. Because the payment structure of the lease in this case returns capital to the lender sooner, reducing its risk, the lender would typically require a lower rate of interest on the borrowing. Therefore, all other things being equal, in this example the IBR estimated for the lease should be lower than the interest rate on the note.
- **Prepayment features.** If the reference borrowing includes lessee and/or lessor prepayment options and the lease does not, the effect of those

prepayment options on the interest rate of the borrowing should be removed from the estimated IBR. The effect of prepayment options can often be obtained from third-party financial data providers.

- **The lease term.** If the lease term differs from the term of the reference borrowing (e.g. a 3-year lease term compared to a 7- or 10-year note), the IBR should be adjusted to reflect the effect on the rate of the different term. It may frequently be the case that a shorter term lowers the applicable interest rate because of the decreased risk to the lender.
- **Economic environment.** Both of the following reflect example economic environment considerations.
  - **Changes from passage of time.** If the reference borrowing was entered into significantly before the lease commencement date, changes in the economic environment (e.g. changes in the overall interest rate environment) in the intervening period generally need to be considered and adjusted for.
  - **Different economic environment.** The discount rate for a lease must consider the economic environment in which it was entered into. If this differs from the economic environment of the market in which the lessee entered into its reference borrowing, those economic differences generally must be accounted for. For example, prevailing interest rates or other borrowing costs in one country or region may not be the same as those in another country or region.
- **Foreign currency.** A lessee should use an IBR that reflects the interest rate at which it could borrow in that foreign currency (see Question 5.6.55). If that differs from the rate at which it could presently borrow in the currency of the reference borrowing, an adjustment generally needs to be made.
- **Lessee renewal options.** If a lessee elects an accounting policy to consider its ability to renew/extend the lease in determining its discount rate for the lease (see paragraph 6.6.140), unless the reference borrowing also includes similar renewal/extension options, the lessee will need to consider that difference between the reference borrowing and the lease when making adjustments to the IBR.



## Question 5.6.67A Over-collateralization

### Is a lessee required to adjust its incremental borrowing rate if it reflects over-collateralization?

**Background:** Frequently, as discussed in Question 5.6.67, a lessee may use an unsecured (non-collateralized) borrowing as an input to derive its incremental borrowing rate (IBR).

However, a lessee may also have one or more secured (collateralized) borrowings to use as inputs to estimate its IBR, and it is possible that the reference borrowing is *over-collateralized*. For example, any 'reference

borrowing' (see Question 5.6.67) for which the proceeds are less than the secured principal balance (e.g. the borrower received \$90, but is required to provide collateral necessary to secure the \$100 principal balance) could be considered over-collateralized.

If a lessee uses an over-collateralized reference borrowing as the starting point for its IBR estimation, the question arises as to whether the lessee *must* adjust for the effect of over-collateralization.

**Interpretive response:** No. While we believe it would be acceptable to adjust for over-collateralization of a reference borrowing when estimating IBR, we do not believe Topic 842 *requires* a lessee to adjust for the effect of using an over-collateralized reference borrowing starting point.

While Topic 842 is explicit that the lessee's IBR must be a fully collateralized rate (the FASB affirmed its intent on this point at a November 2017 Board meeting), there is no explicit guidance, nor has the FASB commented on, whether an adjustment to the IBR *must* be made for the effect of over-collateralization. Thus, we do not believe making an adjustment to the IBR for over-collateralization is required.



## Question 5.6.67B Anomalous incremental borrowing rate

### Is it appropriate to attempt to 'normalize' an incremental borrowing rate that appears anomalous?

**Background:** A lessee's incremental borrowing rate (IBR) is a point-in-time estimate made at lease commencement, the effective date of a lease modification or the date of certain lessee remeasurements.

That point-in-time estimate may appear anomalous – i.e. abnormally high or abnormally low – if the estimation date occurs during an expected short-term period of economic instability (e.g. due to COVID-19). The rate may appear anomalous because of a sudden change in (1) interest rates and/or (2) the lessee's borrowing costs (e.g. because its credit rating declines, or because it has drawn down on all existing credit facilities).

An IBR determined during such periods may be anomalous to IBRs determined during other periods or what the lessee forecasts its IBR will be again in the near future.

**Interpretive response:** No. Although the IBR may in fact be anomalous, we do not believe it is appropriate to attempt to normalize the rate with adjustments the lessee would not otherwise make.

For example, if a key input to the IBR is the current risk-free rate (e.g. US treasury bond rate), to which the lessee adds an appropriate credit spread (see Question 5.6.68), the lessee should not use an average of risk-free rates from different points in time to adjust for a current risk-free rate that is perceived to be abnormally high or abnormally low.



### Question 5.6.68

#### **Existing borrowing as a starting point for estimating the incremental borrowing rate**

#### **Is a lessee required to estimate its incremental borrowing rate by adjusting to/from an existing borrowing?**

**Interpretive response:** No. While we believe a lessee may estimate its incremental borrowing rate by making adjustments to the interest rate on an existing borrowing, it is not required to take that approach.

For example, as illustrated in Example 5.6.30, it may instead be that the lessee will use relevant market and other indications to calculate a credit spread, which is the difference in yield between a risk-free debt security such as a US Treasury bond and another debt security with the same maturity but of lesser quality. The lessee then adds the calculated credit spread to an appropriate risk-free rate. The appropriate risk-free rate plus the calculated credit spread will equal the incremental borrowing rate to be used as the discount rate for the lease.

The appropriate risk-free rate to use will depend on the facts and circumstances. For example, as illustrated in Example 5.6.30, the currency in which the lease is denominated may influence the risk-free rate that should be used.

As a final note, while we believe a lessee is not required to adjust from an existing borrowing when estimating its incremental borrowing rate, if a lessee has existing publicly traded debt, we believe it would generally not be appropriate for the lessee to ignore current market indications about that debt when estimating its incremental borrowing rate.



### Example 5.6.30

#### **Lessee determination of incremental borrowing rate (2)**

Topic 842 does not provide specific guidance for estimating the incremental borrowing rate (IBR) for a lease. Therefore, the following example is not necessarily the only acceptable method for doing so, and the adjustments illustrated may not be the only adjustments that a lessee may need to consider.

#### **Background**

In January Year 9, Lessee LE enters into an airplane lease with Lessor LR, a Japanese entity. The lease has a non-cancellable term of 10 years with an option for LE to renew the lease for an additional 5 years. At lease commencement, it is not reasonably certain that LE will exercise the renewal option. LE agrees to pay LR ¥40 million (Japanese yen) per year in arrears for the right to use the airplane.

The rate implicit in the lease is not readily determinable, and LE is not eligible for (or has elected not to use) the risk-free discount rate practical expedient.

Therefore, LE needs to estimate and use its IBR as the discount rate for the lease.

### **Effect of LE renewal options**

LE has made a policy election not to consider lessee options to extend the lease that it is not reasonably certain to exercise when estimating the IBR for its leases. If LE were to do so, this would affect its IBR estimation. Additionally, LE's election means that if the lease term subsequently changes for this lease, the discount rate for the lease will be updated when remeasuring the lease (see paragraph 6.6.140).

### **Observable starting points**

LE has a corporate BBB credit rating, and has had that same credit rating for the past 5 years.

In addition, LE has two borrowings outstanding:

- A short-term revolving credit facility with a maximum drawdown of \$45 million paying a floating interest rate of LIBOR plus 175 basis points, payable quarterly and secured by the receivables and inventory of LE.
- A 15-year \$50 million senior, unsecured note, issued in February Year 6, with a fixed interest rate of 5.12% per annum. Interest is payable semi-annually and principal is repaid at maturity. The senior note is prepayable by LE without a penalty.

### **Estimating LE's IBR**

In estimating the IBR for its airplane lease with LR, LE considers the definition of IBR and estimates the rate of interest that it would have to pay on a fully collateralized basis to borrow an amount equal to the total lease payments (¥400 million), repaid in equal payments over 10 years, as of the lease commencement date (estimation date).

In the absence of a borrowing that directly matches the requirements of the IBR definition, LE will use its own borrowings and market reference points to estimate the IBR. LE considers observable inputs as of the estimation date, including its credit rating, existing borrowings and other relevant borrowing rates, such as risk-free rates like the US Treasury rate or the Japanese Government Bond rate.

LE notes that none of those observable inputs provide an appropriate IBR without adjustment. Using an unadjusted risk-free rate is not appropriate; LE's credit rating implies a substantially higher borrowing rate than the risk-free rate.

Common items for which adjustments to observable market reference points may be necessary include the following (not exhaustive) – see Question 5.6.67:

- the effect of prepayment or other options in reference debt yields (when such options do not exist in the lease);
- the effect of security or collateral – e.g. when the market reference point is the pricing of an unsecured borrowing;
- level payment (amortizing) structure (versus a structure that repays all of the principal at maturity);
- lease term – e.g. if shorter or longer than the term(s) of the lessee's existing borrowing(s); and/or

- lease payments denominated in a currency different from the currency of the lessee's existing borrowings or other market reference points.

For this lease, items for LE to consider include:

- LE's senior unsecured borrowings:
  - have prepayment options; and
  - are not secured (collateralized).
- LE's borrowings and the risk-free rates identified repay principal at the end of the borrowing period, rather than over the borrowing period;
- LE's borrowings are for terms that differ from the 10-year lease term;
- None of LE's borrowings are in Japanese Yen; and
- LE's borrowings (and the rates reflected in those borrowings) were obtained significantly before the lease commencement date.

Subject to materiality, LE must make an adjustment from one or more of its observable reference points to arrive at an appropriate IBR for each of the above items. Judgment will be needed to estimate the effect of each adjustment. LE may require assistance from qualified treasury or valuation specialists.

#### **Scenario 1: LE unsecured debt is publicly traded**

After considering available observable market inputs, LE decides that information about its 15-year senior unsecured notes provides the best starting point (or basis) for estimating its IBR for the subject lease. If a traded market indication reflecting this LE unsecured debt is available as of the estimation date, it must be considered, because it will have a yield observation that reflects current market conditions (see Step 1 below).

LE concludes that its revolving credit facility reflects a borrowing that is too short-term to be adjusted to the lease term and may or may not reflect a current market spread over LIBOR for LE. Risk-free rates do not reflect LE's borrowing rates.

Given the choice of starting point, LE takes the following steps to estimate the IBR. In this case, LE decides to estimate an appropriate credit spread (Steps 1-4) and add that to an appropriate risk-free rate (Step 5) to arrive at its IBR.

Step	Adjustment <sup>1</sup>
<b>Step 1:</b> Estimate a credit spread reflecting the credit worthiness of LE.	Because the senior unsecured debt is traded, an indication of the credit spread for the debt as of the estimation date, removing the effect of prepayment options, can be obtained directly from third-party financial data providers.
<b>Step 2:</b> Adjust the credit spread for payment structure.	The credit spread obtained in Step 1 represents the spread appropriate for a series of interest payments over 12 years (time until maturity of the unsecured note issued in Year 6), and then repayment of the principal at the maturity date.  The payment structure of the note does not reflect repayment of principal over its term; therefore, the credit spread should be adjusted to reflect the creditworthiness of LE assuming this repayment structure. This adjustment lowers the credit spread,

Step	Adjustment <sup>1</sup>
	because payments returning cash to the lender sooner reduce lender risk.
<b>Step 3:</b> Adjust the credit spread for the effect of security (collateral).	The duration-adjusted credit spread reflects an unsecured borrowing. An adjustment should be made to reflect security (collateral). Adding security to an unsecured note decreases the credit spread, leading to a lower overall IBR when added to the risk-free rate in Step 5.
<b>Step 4:</b> Adjust for the term of the lease.	The unsecured note credit spread, adjusted in Steps 1 to 3, should be further adjusted to reflect a maturity similar to the 10-year lease term.
<b>Step 5:</b> Add risk-free rate.	The credit spread (see Steps 1 through 4), is added to a level payment adjusted risk-free rate with a 10-year tenor. Because the lease payments are in Japanese yen, a Japanese sovereign yield is used in this step (rather than, for example, a US Treasury rate). <sup>2</sup> The credit spread added to the level payment adjusted risk-free rate is the estimated IBR for the lease in this example.

Notes:

1. Quantifying the effect on the IBR (e.g. in terms of basis points to add or deduct from the rate being calculated) will be specific to the facts and circumstances, and may require the assistance of qualified treasury/valuation specialists.
2. Although not the general case, in some markets there is evidence that translation of the spread may be warranted. This can be apparent when an issuer issues bonds with the same terms, on the same day in two different countries, but the par interest rate is different. In these cases, consultation with a specialist may be advisable.

### ***Scenario 2: LE unsecured debt is not publicly traded***

In this scenario, if the entity has a credit rating that is current as of the estimation date, the rating may be used to obtain generic market yields or spreads from third-party financial data providers to perform Step 1.

If no credit rating is available, it is possible to use the interest rate on LE's debt as of the issuance date in Year 6 to imply a credit rating by obtaining the generic credit rating curve with a yield at the maturity of the unsecured debt that is closest to the interest rate of the unsecured note (5.12%). If it is reasonable to assume no changes to LE's credit position, the generic rate available for this credit rating at the estimation date may be a good starting point for Step 1. If there is no way to determine whether there have been changes to LE's credit profile, then establishing a synthetic (or shadow) credit rating may be required (see Scenario 3).

Once Step 1 has been completed, the remaining steps are substantially the same as those outlined in Scenario 1.

### ***Scenario 3: LE has no issued debt***

In this scenario, LE has no outstanding borrowings, and therefore a synthetic credit rating as of the estimation date needs to be developed. A synthetic credit rating is an internally generated rating based on factors that a credit rating agency (or similar) would typically analyze when establishing an entity's credit

rating. This synthetic credit rating may be estimated (e.g. by a specialist) or potentially provided by a bank. Once a rating is estimated, it can be used to obtain relevant, comparable market information, such as market implied credit spreads for entities with a similar credit profile or yields as of the estimation date. These observable market indications may be a good starting point for Step 1.

Once Step 1 has been completed, the remaining steps are substantially the same as those outlined in Scenario 1.



### Example 5.6.40

#### **Lessee elects risk-free discount rate practical expedient**

*This example assumes the same facts and circumstances as in Example 5.6.30, except that LE is a private company (LE is not defined as either a private or a public company in Example 5.6.30).*

As a private company, LE elects the risk-free discount rate practical expedient for its leases of airplanes. In addition to selecting a risk-free rate for a period comparable to the 10-year lease term, LE considers that the lease is denominated in Japanese yen. Therefore, LE uses the same 10-year Japanese sovereign yield used in Step 5 of Example 5.6.30, Scenario 1.



### Question 5.6.69

#### **Negative incremental borrowing rates**

### **Can the incremental borrowing rate for a lease be negative?**

**Interpretive response:** Yes. While we would not expect it to be common, there is nothing in Topic 842 that precludes that result. A negative incremental borrowing rate may result if the lease payments are denominated in the currency of a jurisdiction that is experiencing negative interest rates at the lease commencement date.

However, even if the lessee starts from a negative interest rate starting point (e.g. a negative risk-free interest rate – see Question 5.6.68), adjustments to that starting rate such as those described in Questions 5.6.67 and 5.6.68 may result in the final incremental borrowing rate being positive.



### Question 5.6.69A

#### Negative risk-free discount rates using practical expedient

##### When using the risk-free rate practical expedient, can the discount rate for a lease be negative?

**Background:** Question 5.6.69 observes that a lessee's incremental borrowing rate can be negative. As private entities have adopted Topic 842, the question has arisen about whether the discount rate for a lease determined using the risk-free rate practical expedient (see paragraph 5.6.30) can also be negative. Such a result could arise for similar reasons as described in Question 5.6.69.

**Interpretive response:** Yes. Like with a negative incremental borrowing rate, there is nothing in Topic 842 that precludes that result.

In addition, we do not believe it would be appropriate to avoid this outcome, for example, by:

- not using a risk-free discount rate when the lessee has previously elected the practical expedient for other leases of that class of underlying asset;
- using an inappropriate risk-free rate (e.g. from another jurisdiction or using a rate for a term not comparable to the lease term); or
- otherwise adjusting the rate (including using a floor of zero).



### Question 5.6.70

#### Grant received by lessor from a government agency

##### How does a grant received by a lessor from a government agency as an incentive to build an underlying asset affect the asset's fair value?

**Interpretive response:** The fair value of an asset is not affected by a grant received by a lessor from a government agency to build the asset that is not ongoing or recurring. Fair value is defined as 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. Because a market participant would not pay additional consideration for an asset based on a prior government grant, such a grant does not affect the fair value of that asset. [\[Master Glossary\]](#)

However, if a lessor is entitled to ongoing tax benefits as a government incentive to build an asset, that may affect the fair value of the leased asset if those benefits transfer to an unrelated third-party buyer of the asset if the lessor sold the asset. This is because, in that case, a market participant would generally factor the ongoing tax benefits into the price it would be willing to pay for the asset.



### Question 5.6.80

#### **Considering loan origination fees in determining the incremental borrowing rate**

#### **Should a lessee factor expected loan origination fees into determining its incremental borrowing rate?**

**Interpretive response:** Yes. When the lessee's incremental borrowing rate is used as the discount rate for the lease (see Question 5.6.20), it is intended to reflect the interest rate the lessee would pay to obtain a collateralized loan for the amount of the 'lease payments', borrowed for a term equal to the 'lease term'. The effective interest rate a lessee would pay for such a loan would be affected by any loan origination fees and, therefore, the incremental borrowing rate should also consider those fees.



### Question 5.6.90

#### **Effect on incremental borrowing rate of inability to obtain financing**

#### **How should a lessee determine its incremental borrowing rate when it is unable to obtain third-party financing?**

**Background:** A lessee's credit standing or current financial condition may mean the lessee would be unable to obtain a loan from a third-party lender, or issue debt (e.g. notes), in an amount equal to the 'lease payments'.

**Interpretive response:** In such cases, and assuming the rate implicit in the lease is not readily determinable (see Question 5.6.20), the lessee must still somehow determine its incremental borrowing rate to establish a discount rate for the lease. Because the lessee may not be able to obtain a bank quote or similar information (i.e. because the bank would not grant the loan), we believe it should base its incremental borrowing rate on available third-party information. For example, if comparable company collateralized borrowing information is available, that could be used to approximate the lessee's own incremental borrowing rate. Alternatively, if such information is not available, the lessee could use information about interest rates on very low-grade debt and adjust a rate determined in that manner for the effect of collateral (see Question 5.6.66).



#### **Comparison to legacy US GAAP**

#### **Use of lessor's implicit rate when it is higher than lessee's incremental borrowing rate**

5.6.90 Topic 842 requires the lessee to discount future lease payments using the rate implicit in the lease when it is readily determinable even if it is higher

than the lessee's incremental borrowing rate. Topic 840, like Topic 842, required the lessee to use the rate implicit in the lease if it was practicable to do so, but only if that rate did not exceed the lessee's incremental borrowing rate. [840-10-25-31(b)]

5.6.100 This is a difference between Topic 842 and Topic 840 that, in theory, could result in a lessee recognizing smaller lease assets and lease liabilities and that could also affect lease classification – i.e. because the present value of the lease payments and any lessee residual value guarantee are less when using a higher discount rate. However, because of the infrequency with which lessees are able to determine the rate implicit in the lease, the circumstances in which a lessee uses a rate implicit in the lease that is higher than its incremental borrowing rate are likely to be rare.

#### **Required use of a secured incremental borrowing rate**

5.6.110 The definition of incremental borrowing rate in Topic 842 requires that the rate reflect a secured borrowing rate – i.e. on a 'collateralized basis'. Under Topic 840, the lessee could generally use a secured or unsecured rate as long as it was consistent with the financing that would have been used had the underlying asset been purchased, rather than leased. Therefore, Topic 840 did not require the use of a secured borrowing rate like Topic 842 does. [840 Glossary]

#### **'Funds necessary to purchase the leased asset' vs. 'an amount equal to the lease payments'**

5.6.120 The Topic 840 definition of incremental borrowing rate referred to the rate that the lessee would have incurred to borrow the funds necessary to purchase the leased asset. Conversely, Topic 842 states that the incremental borrowing rate is that which the lessee would pay to borrow on a collateralized basis over a similar term an amount equal to the *lease payments*. [840 Glossary]

5.6.130 This change to the definition of incremental borrowing rate arose because under Topic 842 lessees will be capitalizing most leases, rather than just capital leases. As a result, the Board concluded that the interest rate a particular entity, with its individual credit rating and other entity-specific circumstances, might have to pay to borrow the funds necessary to purchase the underlying asset in many operating lease scenarios (e.g. a three- or five-year lease of real estate or a long-lived asset such as a ship or an airplane) may differ substantially from the interest rate that same entity would pay to borrow an amount equal to the lease payments (i.e. the rate to finance the purchase of the underlying asset would typically be higher).

5.6.140 Therefore, the Topic 840 definition of incremental borrowing rate, if used in Topic 842, would likely have resulted in discount rates unrelated to the lessor's pricing in the lease (for which the incremental borrowing rate is intended to serve as a readily determinable proxy) and in inappropriately measured lease assets and lease liabilities.

#### **Initial direct costs and the rate implicit in the lease**

5.6.150 Under Topic 840, the rate implicit in the lease did not take into account the lessor's initial direct costs. As defined in Topic 842, the rate implicit in the lease is lower than that determined under Topic 840 when the lessor defers initial direct costs. However, this difference is mechanical in nature; instead of separately deferring initial direct costs for sales-type and direct financing leases

as was the case under Topic 840, the initial direct costs are automatically included in the lessor's net investment in the lease through the determination of the implicit rate. Lease income and the lessor's net investment in the lease are unaffected by this change in mechanics. [\[840 Glossary\]](#)

## 5.7 Economic life of the underlying asset

5.7.10 The economic life of an asset is either the period over which the asset is expected to be economically usable by one or more users or the number of production or similar units expected to be obtained from the asset by one or more users. [\[842 Glossary\]](#)

5.7.20 In contrast to the definition of economic life, the useful life of an asset (i.e. the period over which an entity will depreciate the asset) is the period over which the asset is expected to contribute directly or indirectly to future cash flows. The useful life of an asset can differ depending on the asset's intended use by its current owner. [\[842 Glossary\]](#)

5.7.30 Consistent with Topic 840, the Topic 842 definition of economic life will result in a period that is at least as long as, and typically longer than, the useful life.

5.7.40 'Economically usable' is not a defined term in US GAAP. However, this phrase, when used in the existing definition of economic life, generally refers to the period over which the asset is expected to be economically viable because the benefits it can produce exceed the costs to replace it or undertake major repairs or an overhaul.

5.7.50 The phrase 'by one or more users' is intended to convey that the economic life of an asset is an assessment that considers the perspective of the current lessee or owner *and* any future lessees or owners.



### Example 5.7.10

#### Economic life vs. remaining useful life of an asset

Lessor LR enters into a 15-year lease of a building with Lessee LE. The building is 15 years old at lease commencement and LR has owned the building since its construction. LR is in the business of leasing buildings and owns other, similar buildings that it also leases.

LR typically assigns similar buildings a 30-year useful life because it expects to use the buildings for that period in its leasing business. LR's customers generally prefer newer buildings, so LR does not typically keep buildings longer than 30 years. Therefore, at lease commencement, the remaining useful life of the asset is 15 years ( $30 - 15 = 15$ ).

In determining the economic life of the leased building, however, LR (and LE) consider the overall condition of the building at lease commencement and whether it remains economically usable past the end of the 15-year lease term.

- From LR's perspective, it expects to be able to sell the building for more than salvage value at the end of the lease term and that another entity

would be able to make economic use of the building for at least another 20 years following the lease. Consequently, LR concludes that the building has a remaining economic life of 35 years at lease commencement.

- Without specific knowledge of LR's useful life assigned to the building, LE similarly considers the age and condition of the building, as well as information about the economic lives of similar buildings. Based on the facts in this example, LE is likely to also conclude that the remaining economic life of the building at lease commencement is significantly in excess of the 15-year lease term.



## Comparison to legacy US GAAP

### Definition of estimated economic life

5.7.60 The Topic 840 definition of estimated economic life for purposes of lease classification was “[t]he estimated remaining period during which the property is expected to be economically usable by one or more users, with normal repairs and maintenance, for the purpose for which it was intended at contract inception, without limitation by the lease term.” [\[840 Glossary\]](#)

5.7.70 This differs from the Topic 842 definition of economic life (which replaces the definition in the preceding paragraph in the ASC Master Glossary), for example, because the Topic 842 definition does not refer to ‘normal repairs and maintenance’ or to ‘the purpose for which it was intended at contract inception’. However, the two definitions will likely result in similar conclusions in most cases. We believe the Board did not intend to significantly change practice with respect to the application of ‘economic life’; instead, the wording changes were made to align the wording of the definition with IFRS Accounting Standards.

## 5.8 Portfolio approach



### Excerpt from ASC 842-20

#### 55 Implementation Guidance and Illustrations

##### General

- > Illustrations
- > Illustration of Discount Rate

**55-17** Example 2 illustrates the determination of the discount rate for the lease.

- • > Example 2—Portfolio Approach to Establishing the Discount Rate for the Lease

**55-18** Lessee, a public entity, is the parent of several consolidated subsidiaries. During the current period, 2 subsidiaries entered into a total of 400 individual leases of large computer servers, each with terms ranging between 4 and 5 years and annual payments ranging between \$60,000 and \$100,000, depending on the hardware capacity of the servers. In aggregate, total lease payments for these leases amount to \$30 million.

**55-19** The individual lease contracts do not provide information about the rate implicit in the lease. Lessee is BBB credit rated and actively raises debt in the corporate bond market. Both subsidiaries are unrated and do not actively engage in treasury operations in their respective markets. On the basis of its credit rating and the collateral represented by the leased servers, Lessee's incremental borrowing rate on \$60,000 through \$100,000 (the range of lease payments on each of the 400 leases) would be approximately 4 percent. Lessee notes that 5-year zero-coupon U.S. Treasury instruments are currently yielding 1.7 percent (a risk-free rate). Because Lessee conducts its treasury operations centrally (that is, at the consolidated group level), it is reasonably assumed that consideration of the group credit standing factored into how each lease was priced.

**55-20** Lessee may determine the discount rate for the lease for the 400 individual leases entered into on different dates throughout the current period by using a portfolio approach. That is, Lessee can apply a single discount rate to the portfolio of new leases. This is because during the period, the new leases are all of similar terms (four to five years), and Lessee's credit rating and the interest rate environment are stable. Because the pricing of the lease is influenced by the credit standing and profile of Lessee rather than the subsidiaries (that is, because Lessee conducts treasury operations for the consolidated group), Lessee concludes that its incremental borrowing rate of 4 percent is an appropriate discount rate for each of the 400 leases entered into by Lessee's 2 subsidiaries during the period. Because Lessee is a public entity, it is not permitted to use a risk-free discount rate.

5.8.10 A lessee or lessor may apply the guidance in Topic 842 to a portfolio of leases with similar characteristics (size and composition) if the entity reasonably expects that the application of the leases model to the portfolio will not differ materially from the application to the individual leases in that portfolio.

[842-20-55-18 – 55-20, ASU 2016-02.BC120–BC121]



## Observation

### Portfolio approach guidance aligns with Topic 606

5.8.20 The portfolio approach permitted in applying Topic 842 is, and was intended by the Board to be, substantially similar to that included in the new revenue recognition standard, which allows entities to apply the accounting for an individual contract with a customer to a portfolio of contracts under similar circumstances (see chapter 2 of KPMG Handbook, [Revenue recognition](#)).

[ASU 2016-02.BC120–BC121]



## Observation

### **Cost vs. benefits of applying a portfolio approach**

5.8.30 The Board does not expect entities to perform quantitative evaluations to determine whether the portfolio approach differs materially from the application of Topic 842 to the individual leases in that portfolio. Instead, entities should be able to take a reasonable approach, applying judgment in selecting the size and composition of the portfolio – e.g. type of underlying asset, lease term, geographic locations. [\[ASU 2016-02.BC120\]](#)

5.8.40 The Board noted that the cost relief of applying the portfolio approach could be particularly high for certain aspects of Topic 842 that involve judgments and estimates, such as determining the discount rate or determining and reassessing the lease term. For example, an entity may be able to establish a single discount rate applied to all leases in a portfolio because using that discount rate would not result in a materially different outcome than using a discount rate determined on a lease-by-lease basis. Example 2 in Subtopic 842-20 demonstrates application of the portfolio approach to determining the discount rate. [\[ASU 2016-02.BC121\]](#)



## Observation

### **Assessing impairment for ROU assets in a lease portfolio**

5.8.50 During deliberations of the portfolio approach, the Board expressed a view that if some, but not all, ROU assets within a lease portfolio are impaired, it would be inappropriate to continue to account for those leases within a portfolio if the impairment is material to the entity.

5.8.60 Section 6.5 discusses application of the Topic 360 impairment guidance to leases of lessees, and section 7.3.2 discusses impairment of the lessor's net investment in sales-type and direct financing leases.



## Question 5.8.10

### **Applying the portfolio approach to multiple separate lease components**

## **Can a lessee apply the portfolio approach to multiple separate lease components assigned to different Topic 360 asset groups?**

**Background:** Under Topic 842, the portfolio approach is available for leases (or separate lease components) with similar characteristics when application of the leases model to the portfolio will not differ materially from applying it on an individual lease basis (see paragraph 5.8.10). The Board's intention in allowing the portfolio approach was to address the practical challenges in accounting for

a large number of leases, but not to create material differences in accounting results or conclusions.

**Interpretive response:** The answer to this question depends on whether the lessee intends to use the portfolio approach:

- to account for multiple leases as a single lease – i.e. to recognize only a single ROU asset and lease liability for the portfolio of leases; or
- to make judgments and estimates (e.g. in determining the discount rate or lease term) about each lease within the portfolio.

We do not believe a lessee can use the portfolio approach to account for multiple leases as a single lease if the ROU assets that would result from accounting for those multiple leases separately would be assigned to different Topic 360 asset groups. To do so would be inconsistent with the requirement that the effects on the financial statements of accounting for those multiple leases as a single lease do not differ materially from the accounting for the leases individually.

A lessee may, however, use a portfolio approach to make judgments and estimates about leases even if the ROU assets resulting from those leases are assigned to different Topic 360 asset groups. For example, it is acceptable to use a portfolio approach to determine the discount rate or the lease term for a portfolio of leases with similar characteristics even though the ROU assets for those leases will be assigned to different Topic 360 asset groups.



### Example 5.8.10 Applying the portfolio approach to leases of vehicles

Lessee LE provides goods to a wide variety of customers. During the first quarter of the current year, LE entered into a total of 50 individual leases of vehicles for its sales force. The 50 leases have terms ranging from four to five years and commence on different dates (within the span of a calendar quarter), and the annual lease payments are between \$5,000 and \$6,000 for each vehicle.

Because there is a narrow range of fair values and estimated remaining economic lives for the vehicles, LE reasonably expects that the effect of applying the requirements of Topic 842 to its 50 vehicle leases as a portfolio will not differ materially from applying the requirements individually to each lease. Therefore, LE decides to use a portfolio approach in determining the discount rate for each of the 50 leases. LE will use a single discount rate in applying the measurement requirements in Topic 842 to each of the 50 leases in the portfolio.

Because LE is unable to determine the rate implicit in the 50 leases (see section 5.6), it uses its incremental borrowing rate. Because LE applies a portfolio approach, it determines the incremental borrowing rate it will use for each of the 50 vehicle leases based on the interest rate it would pay for a secured loan in the amount of the lease payments for a representative lease in the portfolio (i.e. an amount between \$5,000 and \$6,000) for a representative lease term (between four and five years).

# 6. Lessee accounting

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New item added in this edition: \*\*

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**Comparison to legacy US GAAP****Comparison to legacy US GAAP**

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### **Comparison to legacy US GAAP**

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- 6.6.80 Variable lease payments indexed to CPI
- 6.6.90 Remeasurement and reallocation of the consideration in the contract

### Comparison to legacy US GAAP

## 6.7 Lease modifications (Step 8B)

### Observation

Lease modifications vs. lease remeasurements resulting from reassessments

### Questions

- 6.7.05 Contract modifications not in writing
- 6.7.06 Contract changes only affecting variable or contingent payments
- 6.7.07 Are rent concessions lease modifications?
- 6.7.08 Lessee short payment of rent – lessee accounting
- 6.7.09 Modifications that add a right(s) of use *and* make other changes
- 6.7.10 Method of accounting for lease modifications that decrease the lessee's right(s) of use
- 6.7.11 Acceptability of methods for remeasuring ROU asset in partial lease termination
- 6.7.15 Termination penalties in a partial termination scenario
- 6.7.20 Modifications that both decrease the lessee's right(s) of use and extend the lease term

- 6.7.25 Continued right of use after effective date of modification
- 6.7.30 Terminating one lease and entering into another with the same lessor
- 6.7.40 Lessor payment for terminating one lease and entering into another

### **Examples**

- 6.7.08 Lessee accounting for short payments not permitted by the contract
- 6.7.10 Modification that adds a right of use
- 6.7.20 Modification that extends the lease term only
- 6.7.25 Modification – original lease is a finance lease and the modified lease is an operating lease
- 6.7.30 Partial lease termination
- 6.7.35 Modification that both decreases the lessee's right of use (with immediate effect) and extends the lease term
- 6.7.36 Modification that both decreases the lessee's right of use (with delayed effect) and extends the lease term
- 6.7.40 Master lease agreement

### **Comparison to legacy US GAAP**

## **6.8 Lease terminations**

### **Question**

- 6.8.10 Lessee recognition of lease cancellation payment premium

### **Example**

- 6.8.10 Full lease termination

## **6.8A Lease accounting — lessee in bankruptcy**

## **6.9 Presentation (Step 9)**

- 6.9.1 Balance sheet
- 6.9.2 Income statement
- 6.9.3 Statement of cash flows

### **Observation**

Lessee balance sheet presentation focused on user needs

### **Questions**

- 6.9.10 Classification of ROU assets and lease liabilities
- 6.9.15 Change in approach used to determine classification of lease liabilities \*\*
- 6.9.20 Presentation of variable lease payments

- 6.9.30 Presentation of operating lease cost after an impairment or planned abandonment of the ROU asset
- 6.9.40 Presentation of lease termination or remeasurement gain when the ROU asset was previously impaired or abandoned

**Example**

- 6.9.10 Classification of lease liabilities

## How the standard works

- A lessee recognizes on its balance sheet a (financial) lease liability and a (nonfinancial) ROU asset for all leases, including operating leases, with a 'lease term' (see section 5.3) greater than 12 months.
- A lessee is also permitted, but not required, to recognize a lease liability and an ROU asset for leases with a lease term of 12 months or less.
- The lease classification distinction (operating versus finance lease) continues to exist in Topic 842 but now affects how lessees measure and present lease expense and cash flows not whether the lease is on- or off-balance sheet.

	Balance sheet	Income statement	Profile of total lease cost
Finance lease	<ul style="list-style-type: none"><li>— ROU asset</li><li>— Lease liability</li></ul>	<ul style="list-style-type: none"><li>— <b>Operating expense:</b> Amortization of ROU asset</li><li>— <b>Interest expense:</b> Interest expense on lease liability</li></ul>	<ul style="list-style-type: none"><li>— Front-loaded</li></ul>
Operating lease	<ul style="list-style-type: none"><li>— ROU asset</li><li>— Lease liability</li></ul>	<ul style="list-style-type: none"><li>— <b>Operating expense:</b> Lease expense</li></ul>	<ul style="list-style-type: none"><li>— Generally straight-line</li></ul>

## 6.1 Overview

 **Excerpt from ASC 842-20**

**05 Overview and Background**

**General**

**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 Scope and Scope Exceptions**

**General**

**15-1** This Subtopic follows the same Scope and Scope Exceptions as outlined in the Overall Subtopic.

6.1.10 The steps in the below chart help frame the big picture of lessee accounting that is applied to separate lease components, which is the unit of account in applying Topic 842 (see section 4.1). Steps 1 to 3 deal with concepts and definitions that apply to both lessee and lessor accounting; therefore, they are included in chapter 5 as an introduction to both accounting models. Each of Steps 4 to 9 is discussed in more detail in this chapter.

<b>Step 1:</b> Determine the 'lease term' (see section 5.3)	<b>The lease term is integral to determining:</b> <ul style="list-style-type: none"> <li>— Whether the lease is a short-term lease</li> <li>— The lease payments and the discount rate for the lease</li> <li>— Lease classification</li> </ul>
<b>Step 2:</b> Determine the 'lease payments' (see section 5.4)	<b>The lease payments are integral to:</b> <ul style="list-style-type: none"> <li>— Determining the discount rate for the lease</li> <li>— Determining lease classification</li> <li>— Measuring the ROU asset and the lease liability for a lease</li> </ul>
<b>Step 3:</b> Determine the discount rate for the lease (see section 5.6)	<b>The discount rate for the lease affects:</b> <ul style="list-style-type: none"> <li>— Lease classification</li> <li>— Measurement of the ROU asset and lease liability</li> </ul>
<b>Step 4:</b> Lease classification (see section 6.2)	<b>Lease classification determines:</b> <ul style="list-style-type: none"> <li>— How a lessee measures and presents lease expense and cash flows</li> <li>— How a lessee measures the ROU asset after initial recognition</li> </ul>

<b>Step 5:</b> Initial recognition and measurement (see section 6.3)	<ul style="list-style-type: none"> <li>— A lessee recognizes an ROU asset and a lease liability at the commencement date of the lease (unless the lease is a short-term lease)</li> <li>— The ROU asset and lease liability for finance and operating leases are initially measured in the same way</li> </ul>
<b>Step 6:</b> Subsequent accounting (see section 6.4)	<ul style="list-style-type: none"> <li>— Subsequent measurement of the lease liability is the same for finance and operating leases</li> <li>— Subsequent measurement of the ROU asset differs for finance and operating leases</li> </ul>
<b>Step 7:</b> Impairment testing (see section 6.5)	<ul style="list-style-type: none"> <li>— ROU assets are evaluated for impairment using the long-lived assets impairment guidance (Topic 360)</li> <li>— Impairment of an operating lease ROU asset substantially changes the subsequent accounting for the lease post-impairment</li> </ul>
<b>Steps 8A and 8B:</b> Reassessments and modifications (see sections 6.6 — 6.8)	<ul style="list-style-type: none"> <li>— Lessees may be required to revise the accounting for a lease during the lease term, even if there are no lease modifications</li> <li>— Lessee accounting for lease modifications depends on the nature of the modification</li> </ul>
<b>Step 9:</b> Presentation (see section 6.9)	<ul style="list-style-type: none"> <li>— Finance and operating leases are presented differently in the financial statements</li> </ul>



## Observation

### A more transparent financial statement representation of leases

6.1.20 Topic 842 was developed principally to improve financial statement users' understanding of lessees' lease obligations. In the Board's view, the recognition of ROU assets and lease liabilities for all leases other than short-term leases (see paragraph 6.3.110) will: [\[ASU 2016-02.BC8\]](#)

- result in a more transparent and faithful representation of the rights and obligations arising from leases;
- improve the understanding and comparability of lessees' financial commitments regardless of how the lessee finances the assets used in its business; and
- reduce opportunities for entities to structure leases to achieve a particular accounting outcome on the balance sheet.



### Question 6.1.10

#### **Impact of Topic 842 on performance ratios and financial covenants**

##### **How will the adoption of Topic 842 affect a lessee's performance ratios and financial covenants?**

**Interpretive response:** The requirement to recognize additional assets and liabilities arising from lease transactions may affect some key performance ratios commonly used in credit and investment-making decisions. For example, the additional lease assets and lease liabilities are likely to result in:

- lower liquidity ratios, such as the current ratio (current assets / current liabilities) and quick ratio ((cash + short-term investments + receivables) / current liabilities) because of increased current liabilities (current portion of the lease liabilities); and
- higher working capital turnover (revenue / average working capital) due to reduced working capital because the lease liability is partially current, and a lower asset turnover (revenue / average total assets) due to increased total assets.

Changes to a lessee's balance sheet resulting from the new requirements may affect a lessee's compliance with financial covenants. The existence and magnitude of the effects will depend on lessee-specific facts and circumstances.

However, most financial statement users (e.g. investors and analysts) already adjust lessees' financial statements for operating lease obligations, often overestimating lease obligations compared to what will be recognized under Topic 842.

The Board believes the effects of Topic 842 on financial covenants will not be significant, in part because many loan agreements contain provisions preventing or minimizing defaults solely due to a change in accounting standards; but also because operating lease liabilities are considered operating liabilities, rather than debt, under Topic 842. [\[IASU 2016-02.BC14\]](#)

Categorizing operating lease liabilities as operating liabilities, rather than debt, may mean that Topic 842 will not have a significant effect on debt-based ratios such as the: [\[IASU 2016-02.BC14\]](#)

- debt-to-capital ratio (total debt / (total debt + total equity)) and debt-to-equity ratio (total debt / total equity); and
- weighted-average cost of capital (WACC).

However, entities negotiating debt or similar arrangements that will contain financial covenants may nonetheless want to consider the application of Topic 842 in their negotiations of financial covenants.

## 6.2 Lease classification (Step 4)



### Excerpt from ASC 842-10

#### 25 Recognition

##### General

> Lease Classification

**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).

**25-2** A lessee shall classify a lease as a **finance lease** and a **lessor** shall classify a lease as a **sales-type lease** when the lease meets any of the following criteria at lease commencement:

- a. The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
- b. The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
- c. The lease term is for the major part of the remaining economic life of the underlying asset. However, if the commencement date falls at or near the end of the economic life of the underlying asset, this criterion shall not be used for purposes of classifying the lease.
- d. The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments in accordance with paragraph 842-10-30-5(f) equals or exceeds substantially all of the fair value of the underlying asset.
- e. The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

**25-3** When none of the criteria in paragraph 842-10-25-2 are met:

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

**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).

**25-7** See paragraphs 842-10-55-2 through 55-15 for implementation guidance on lease classification.

## 55 Implementation Guidance and Illustrations

### General

> Implementation Guidance

• > Lease Classification

**55-2** When determining **lease** classification, one reasonable approach to assessing the criteria in paragraphs 842-10-25-2(c) through (d) and 842-10-25-3(b)(1) would be to conclude:

- a. Seventy-five percent or more of the remaining economic life of the underlying asset is a major part of the remaining economic life of that underlying asset.
- b. A commencement date that falls at or near the end of the economic life of the underlying asset refers to a commencement date that falls within the last 25 percent of the total economic life of the underlying asset.
- c. Ninety percent or more of the fair value of the underlying asset amounts to substantially all the fair value of the underlying asset.

**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).

• • > Transfer-of-Ownership Criterion

**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).

• • > Alternative Use Criterion

**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.

• • > Effect of Investment Tax Credits

**55-8** When evaluating the **lease** classification criteria in paragraphs 842-10-25-2(d) and 842-10-25-3(b)(1), the **fair value** of the **underlying asset** should be reduced by any related investment tax credit retained by the **lessor** and expected to be realized by the lessor.

• • > Residual Value Guarantees for a Portfolio of Underlying Assets

**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).

• • > Lease of an Acquiree

**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.

• • > Lease of a Related Party

**55-12** Except for **leases** between entities under common control accounted for in accordance with the practical expedient in paragraph 842-10-15-3A, 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. Additionally, except for leases

between entities under common control accounted for in accordance with paragraph 842-10-15-3A, the classification and accounting for the leases should be the same as for leases between unrelated parties in the separate financial statements of the related parties.

• • > Lease Involving Facilities Owned by a Government Unit or Authority

**55-13** Because of special provisions normally present in **leases** involving terminal space and other airport facilities owned by a governmental unit or authority, the **economic life** of such facilities for purposes of classifying a lease is essentially indeterminate. Likewise, it may not be practicable to determine the **fair value** of the **underlying asset**. If it is impracticable to determine the fair value of the underlying asset and such leases also do not provide for a transfer of ownership or a purchase option that the **lessee** is reasonably certain to exercise, they should be classified as **operating leases**. This guidance also applies to leases of other facilities owned by a governmental unit or authority in which the rights of the parties are essentially the same as in a lease of airport facilities. Examples of such leases may be those involving facilities at ports and bus terminals. The guidance in this paragraph is intended to apply to leases only if all of the following conditions are met:

- a. The underlying asset is owned by a governmental unit or authority.
- b. The underlying asset is part of a larger facility, such as an airport, operated by or on behalf of the lessor.
- c. The underlying asset is a permanent structure or a part of a permanent structure, such as a building, that normally could not be moved to a new location.
- d. The lessor, or in some circumstances a higher governmental authority, has the explicit right under the lease agreement or existing statutes or regulations applicable to the underlying asset to terminate the lease at any time during the lease term, such as by closing the facility containing the underlying asset or by taking possession of the facility.
- e. The lease neither transfers ownership of the underlying asset to the lessee nor allows the lessee to purchase or otherwise acquire ownership of the underlying asset.
- f. The underlying asset or equivalent 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.

**55-14** Leases of underlying assets not meeting all of the conditions in paragraph 842-10-55-13 are subject to the same criteria for classifying leases under this Subtopic that are applicable to leases not involving government-owned property.

• • > Lessee Indemnification for Environmental Contamination

**55-15** A provision that requires **lessee** indemnification for environmental contamination, whether for environmental contamination caused by the lessee during its use of the **underlying asset** over the **lease term** or for preexisting environmental contamination, should not affect the classification of the **lease**.

6.2.10 A lessee determines lease classification for each separate lease component, which is the unit of account in applying Topic 842 (see section 4.1), at the commencement date of the lease (see section 5.1). [842-10-25-1]

6.2.20 The lessee accounting model in Topic 842 is generally intended to classify leases as finance leases when the lease is economically similar to the purchase of a nonfinancial asset. This would be the case when the lessee effectively obtains control of the underlying asset (rather than merely obtaining control over its use for the lease term) by being able to direct its use and obtain substantially all of its remaining benefits as a result of the lease.

[ASU 2016-02.BC56, BC70]

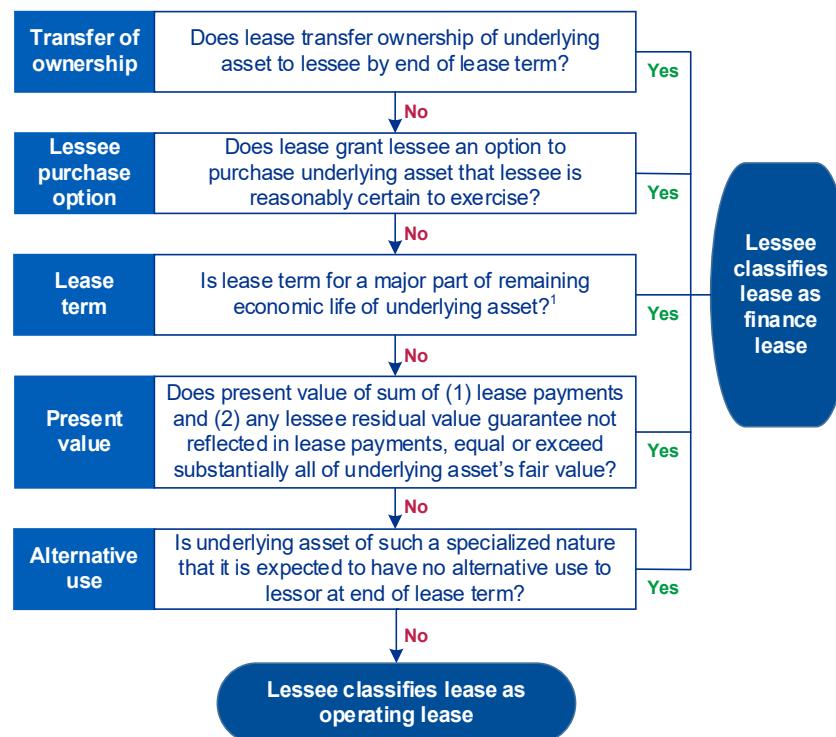
6.2.30 However, in determining lease classification, there is no separate or additional evaluation of this underlying principle. The Board decided that a lease is classified as a finance lease when any one (or more) of five specified tests are met, even if an entity does not believe that the lessee effectively obtains control of the underlying asset as a result of the lease. [ASU 2016-02.BC70-BC71]

6.2.40 Lease classification is not reassessed after the commencement date unless either: [842-10-25-1]

- there is a change in the assessment of either (1) the lease term, or (2) whether it is reasonably certain that a lessee purchase option will be exercised (see section 6.6); or
- the contract that is or contains the separate lease component is modified and that modification is not accounted for as a separate contract (see section 6.7).

6.2.50 The following are the lease classification tests that are applied by lessees. [842-10-25-2 – 25-3]

**Tests:**



Note:

1. If the commencement date is at or near the end of the underlying asset's economic life (see paragraph 6.2.90), which may occur if the underlying asset is used or was leased previously, this test does not apply.

## 6.2.1 Classification tests

### ***Transfer of ownership test***

6.2.60 The transfer of ownership test is met in leases that require: [842-10-55-4 – 55-5]

- the lessor to release the underlying asset from the lease and to transfer ownership to the lessee upon the lessee's performance in accordance with the terms of the lease; or
- the lessee to pay a nominal amount in connection with ownership transfer of the underlying asset – e.g. a minimum statutory fee to transfer ownership.

6.2.70 When ownership of the underlying asset transfers to the lessee only if the lessee elects to pay a specified fee (whether nominal or otherwise) to complete the transfer, it is considered a purchase option that is evaluated the same way as any other lessee purchase option (see paragraph 6.2.80). [842-10-55-6]

### ***Lessee purchase option test***

6.2.80 The lessee purchase option test is met if it is reasonably certain that the lessee will exercise the option. 'Reasonably certain' is a high threshold of probability, and the Board intended the parties to account for lessee options only when the lessee has a compelling economic reason to exercise the option (see section 5.2). [842-10-30-1]

### ***Lease term test***

6.2.90 An entity may use the following thresholds when evaluating the lease term test. [842-10-55-2]

- 75 percent or more of the remaining economic life may be considered a major part of the remaining economic life of that underlying asset.
- A lease that commences with 25 percent or less of the underlying asset's total economic life remaining may be considered to commence at or near the end of the asset's economic life.

6.2.100 When a single lease component contains the right to use more than one underlying asset (see section 4.1), an entity considers the remaining economic life of the predominant asset in the lease component when applying the lease term test. The assessment of which underlying asset is predominant is a qualitative one that requires entities to conclude on the most important element of the lease, which the Board expects to be relatively clear in most cases. If an entity is unable to identify the predominant asset, it might be an indicator that there are additional separate lease components in the contract. [842-10-25-5, ASU 2016-02.BC74]



### Question 6.2.10

#### **Lease classification – lease term test when bright-line thresholds are not used**

#### **How should a lessee evaluate the lease term classification test when it elects not to use the permitted bright-line thresholds?**

**Background:** The Board decided to permit, rather than require, using bright-line thresholds when evaluating the lease term classification tests. [842-10-55-2]

In deciding to permit these thresholds, the Board observed that entities need to operationalize the guidance in a scalable manner, which requires establishing internal accounting policies and controls. However, because these thresholds are characterized as only one acceptable approach to interpreting what ‘major part’, ‘substantially all’ and ‘at or near the end’ mean, entities are permitted to exercise judgment. That means, for example, that amounts below 90 percent could be considered substantially all in the context of the present value test, or that a lease term that is less than 75 percent of the remaining economic life of the underlying asset could be considered a major part of the asset’s remaining economic life in the lease term test. [ASU 2016-02.BC73]

**Interpretive response:** Determining acceptable thresholds to apply to the lease term test when not using the permitted bright lines for major part and at or near the end requires judgment. However, in general, we believe the greater the extent to which the judgments reached stray from these bright lines, the more likely they are to potentially be questioned.

#### **Lease term test**

Consideration of the control classification principle may be useful in determining an appropriate threshold for applying the lease term test. That is, when considering what might be an acceptable threshold other than 75 percent, an entity should consider that the classification test is intended to capture, as finance (sales-type) leases, those leases that give the lessee the ability to both (1) direct the use of the underlying asset and (2) obtain substantially all of the remaining benefits of the underlying asset. [ASU 2016-02.BC70]

This is because, in determining the qualitative threshold for the lease term test (i.e. major part rather than substantially all), the Board considered that most assets, particularly equipment, decline in value in a front-loaded manner; this means that the earlier years of an asset’s economic life provide a disproportionate percentage of the remaining benefits from the underlying asset. Consequently, an entity that controls the use of an asset for only a major part of its remaining economic life may still have the ability to direct its use to obtain substantially all of its remaining benefits. [ASU 2016-02.BC71(c)]

That major part was intended to be a substantively lower threshold than substantially all, also is evidenced by the fact that the 75 percent bright-line threshold for a major part is significantly lower than the 90 percent bright-line threshold for substantially all. This means that a qualitative evaluation of what constitutes a major part of the asset’s economic life should consider the

pattern in which the asset is expected to experience a diminution in economic utility or value.

This evaluation may differ for different classes of underlying assets. For example, it might be less than 75 percent for an asset with a more front-loaded diminution in economic utility or value, but more than 75 percent for an asset that holds its economic utility or value more steadily over time.

### **At or near the end of the economic life**

In general, because there is no guidance provided about what 'at or near the end' means other than the 25 percent bright-line threshold provided in the implementation guidance, we believe entities generally should adhere to the 25 percent bright line.

Unlike the lease term test, the classification principle provides no insight into how to interpret this threshold because the 'at or near the end of the economic life' exception is contrary to the classification principle, rather than an application of that principle, and was adopted for cost-benefit reasons. [ASU 2016-02.BC71(c)]



### Example 6.2.10

#### **Lease classification – lease term test**

Lessee LE and Lessor LR enter into a lease of a piece of used, non-specialized production equipment. The following facts are relevant at the lease commencement date.

Transfer of ownership:	No
Renewal/purchase options:	None
Total economic life of equipment:	20 years
RVG:	None
LE's incremental borrowing rate:	5% (implicit rate cannot be readily determined)
Initial direct costs:	None

In addition, LE evaluates lease classification using the bright-line thresholds – i.e. the 75%, 25% and 90% thresholds for the lease term and present value tests (see paragraphs 6.2.90 and 6.2.110).

Scenario 1: Lease does not begin near the end of the asset's economic life	Scenario 2: Lease begins near the end of the asset's economic life
<b>Additional facts</b> <ul style="list-style-type: none"> <li>— Non-cancellable 5-year lease term.</li> <li>— Equipment has a remaining economic life of 6 years at lease commencement.</li> <li>— Equipment has a fair value of \$30,000 at lease commencement.</li> </ul>	<b>Additional facts</b> <ul style="list-style-type: none"> <li>— Non-cancellable 4-year lease term.</li> <li>— Equipment has a remaining economic life of 4.5 years at lease commencement.</li> <li>— Equipment has a fair value of \$25,000 at lease commencement.</li> </ul>

Scenario 1: Lease does not begin near the end of the asset's economic life	Scenario 2: Lease begins near the end of the asset's economic life
<ul style="list-style-type: none"> <li>Present value of lease payments discounted at 5% is \$24,245 (fixed lease payments of \$5,600 per year in arrears).</li> </ul>	<ul style="list-style-type: none"> <li>Present value of lease payments discounted at 5% is \$21,276 (fixed lease payments of \$6,000 per year in arrears).</li> </ul>
<p><b>Lease classification</b></p> <p>LE classifies the lease as a <b>finance lease</b> based on the following:</p> <ul style="list-style-type: none"> <li>Transfer of ownership test – No</li> <li>Lessee purchase option test – N/A</li> <li>Lease term test – Yes (83%)</li> <li>Present value test (see paragraph 6.2.110) – No (81%)</li> <li>Alternative use test (see paragraph 6.2.150) – No</li> </ul>	<p><b>Lease classification</b></p> <p>LE classifies the lease as an <b>operating lease</b> based on the following:</p> <ul style="list-style-type: none"> <li>Transfer of ownership test – No</li> <li>Lessee purchase option test – N/A</li> <li>Lease term test – N/A (lease commencement falls at or near the end of the equipment's economic life)</li> <li>Present value test (see paragraph 6.2.110) – No (85%)</li> <li>Alternative use test (see paragraph 6.2.150) – No</li> </ul>



### Question 6.2.15

#### Lease classification – applying the 'at or near the end of the economic life' exception in a reassessment

#### Does the 'at or near the end of the economic life' exception to the lease term test apply when reassessing lease classification?

**Background:** Topic 842 states that the 'at or near the end of the economic life' exception applies 'if the *commencement date* of the lease falls at or near the end of the economic life of the underlying asset'. [Emphasis added] [842-10-25-2(c)]

Therefore, the question arises as to whether this exception also applies when lease classification is reassessed *after* the commencement date – e.g. on the effective date of a lease modification or, for the lessee, on remeasurement of the lease due to a change in the lease term or a change in the assessment of a lessee purchase option.

Paragraph 6.2.90 and Question 6.2.10 discuss how to apply the exception.

**Interpretive response:** Yes. The 'at or near the end of the economic life' lease term test exception applies when lease classification is reassessed after lease commencement. If, at the date of reassessment, the underlying asset is at or near the end of its total economic life, then the exception applies. This is regardless of whether the exception also applied at lease commencement or at an earlier classification reassessment date. [842-10-25-15, 25-16(b), ASU 2016-02.BC173]



### Example 6.2.15

#### 'At or near the end of the economic life' exception in a reassessment

Lessor LR leases 10-year-old equipment to Lessee LE that when new has a 20-year economic life. The lease term is 6 years. Because the equipment is only 50% through its total economic life at lease commencement (10 years remaining of 20), the 'at or near the end of the economic life' lease term classification test exception does not apply.

At the end of the 6-year lease term (Year 16 of the equipment's 20-year economic life), LE and LR agree to modify the lease, extending the lease term by 3 years. The modification does not meet the criteria to be accounted for as a separate contract because the extension of the lease term does not grant LE an additional right of use (see paragraph 6.7.30, Note 1, and paragraph 6.7.40); therefore, at the modification date, both LE and LR are required to reassess lease classification.

At the effective date of the modification:

- the remaining lease term of 3 years is more than a major part of the equipment's then-remaining economic life: 3-year lease term / 4-year remaining economic life = 75%; however
- the equipment is also in the last 20% of its total economic life: 4-year remaining economic life / 20-year total economic life = 20%.

Because the underlying equipment is near the end of its total economic life at the effective date of the modification (i.e. within the last 25% thereof), LE and LR do not apply the lease term test when reassessing classification of the lease at that date.

### Present value test

6.2.105 This test is met if the present value of the sum of (1) the lease payments and (2) any lessee residual value guarantee not reflected in lease payments equals or exceeds substantially all of the underlying asset's fair value. See section 5.4 for what constitutes 'lease payments'.

6.2.110 An entity may use a threshold of 90 percent or more when determining what constitutes substantially all of the fair value of the underlying asset.  
[\[842-10-55-2\(c\)\]](#)

6.2.120 When evaluating lease classification, the fair value of the underlying asset is reduced by any related investment tax credit retained, and expected to be realized, by the lessor. [\[842-10-55-8\]](#)

6.2.130 In some cases, it may not be practicable for a lessee to determine the fair value of the underlying asset – i.e. a reasonable estimate of fair value cannot be made without undue cost or effort. Topic 842 notes that practicability is a dynamic concept in that: [\[842-10-55-3\]](#)

- 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.



## Observation

### Fair value practicability exception different from Topic 840

6.2.131 Topic 840 contained guidance under which an entity would not apply the present value lease classification test if the cost and/or fair value of the underlying asset (specifically, a part of a building) was not 'objectively determinable'. [840-10-25-39, 25-69]

6.2.132 Topic 840 also provided guidance about what 'objectively determinable' meant in that context. In particular, that guidance stated: [840-10-25-23 – 25-24]

- evidence other than sales of similar property could meet the objectively determinable threshold – e.g. reasonable estimates of fair value derived from an independent appraisal or replacement cost information; but
- obtaining an appraisal or similar valuation is not a requirement of Topic 840.

6.2.133 In practice, we believe this guidance was frequently used to justify operating lease classification without undertaking the present value test.

6.2.134 There is a misconception that the Topic 842 fair value practicability exception from the present value classification test (see paragraph 6.2.130) is derived from, and therefore intended to be consistent with, the legacy Topic 840 guidance. However, the FASB never decided to carry forward the Topic 840 guidance. Instead, the wording of the Topic 842 practicability exception was drawn from, and is substantially similar to, the fair value practicability exception that existed in Topic 825 (financial instruments) before the adoption of ASU 2016-01. [825-10-50-16 – 50-17]

6.2.135 Topic 825 included the notion that what is 'excessive' in terms of the cost (i.e. what constitutes 'undue cost and effort') to obtain the fair value of the relevant financial instrument considers both the entity *and* the materiality of the instrument to the entity. That is: [825-10-50-17]

- what is excessive for one entity (e.g. a smaller entity) is not necessarily excessive for another entity (e.g. a larger entity); and
- 'excessive' is a higher threshold when the fair value information is more material to the entity's financial reporting.

6.2.136 The FASB noted, in the basis for conclusions to FASB Statement No. 107 (codified in Topic 825), that it expected "in most cases, it will be practicable for an entity to make a reasonable estimate of fair value even of financial instruments that are not readily marketable." [FAS 107.C46]



## Question 6.2.19

**Fair value practicability exception – undue cost and effort****What constitutes 'undue cost and effort' when considering availability of the fair value practicability exception?**

**Interpretive response:** Consistent with our views on Topic 360 (property, plant and equipment), we believe the fair value of individual long-lived assets usually should be determinable either individually or in aggregate *without* undue cost and effort. Therefore, we would generally not expect this exception to apply to leases of entire underlying assets (e.g. machine, vehicle, building) or portions of entire underlying assets that are legally separable (e.g. condominiums), or groups thereof (e.g. a fleet of vehicles).

Determining the fair value of a portion of a larger asset (e.g. floor of a building, cell tower rung, satellite transponder, fiber-optic cable strand) will frequently be more complex than determining the fair value of an entire asset. However, that does not necessarily mean its fair value is not 'determinable without undue cost and effort'.

Given, in particular, paragraph 6.2.135, we believe the more material the effect of the fair value determination on the entity – which *may* be greater, in general, for lessors now that operating leases are recognized on the balance sheet by lessees – the more difficult it is to argue that the cost and effort to determine the fair value of the underlying asset, including obtaining an appraisal or a similar valuation, is 'undue'. For example:

- If the result of the present value test depends on the fair value of the underlying asset, and that test will determine lessor sales-type or operating lease classification for a material lease transaction, significant cost and effort to obtain the underlying asset's fair value is unlikely to be 'undue', even if that requires obtaining an appraisal or similar valuation.
- In contrast, classification of the lease as finance or operating in the same lease transaction *may* not be as material to the lessee's financial reporting as it is to the lessor's because the lease will be recognized on the lessee's balance sheet regardless of classification. In addition, it may frequently be the case that the cost and effort to determine the fair value of the underlying asset is greater for the lessee – e.g. because it does not have access to information the lessor would reasonably be expected to have.

Therefore, it is *possible* the lessee might conclude that the costs and effort it would incur to determine the fair value of the underlying asset are undue. However, before reaching that conclusion, the lessee still needs to consider the effect of the lease's classification on its income statement and on key ratios and metrics important to its financial statement users (e.g. debt ratios or EBITDA); on-balance sheet lease recognition alone will not necessarily make classification less material to the lessee than the lessor.

In addition, it may frequently be reasonable and appropriate to determine the fair value of a portion of a larger asset with reference to the fair value of the larger asset. For example, the fair value of one floor of a five-floor office building in a nondescript geographical area (i.e. higher floor does not provide a better

view or command higher rents) and for which the floors are generally homogenous may be reasonably determined as a proportion of the fair value of the building as a whole. In contrast, the fair value of a fiber strand or a satellite transponder may not reasonably be estimated based on the number of other fiber strands in the cable or transponders in the satellite; this is because of the dependency the fiber strands and transponders have on other components of the larger asset.

Consistent with the views of the FASB (see paragraph 6.2.136), we believe the fair value of an underlying asset should be determinable, without undue cost and effort, in most cases. Regardless of whether the underlying asset is an entire asset or a portion of a larger asset, an entity that believes the fair value practicability exception applies to its facts and circumstances should consult with its auditors and/or other accounting advisors.



### Question 6.2.20

#### **Lease classification – present value test when bright-line threshold is not used**

### **How should a lessee evaluate the present value classification test when it elects not to use the bright-line threshold?**

**Interpretive response:** In general, we believe there is little leeway from the 90 percent bright-line threshold in evaluating the present value test. This is because, unlike ‘major part’ or ‘at or near the end’, ‘substantially all’ is used elsewhere in US GAAP and is interpreted on a mostly consistent basis to mean approximately 90 percent; this includes when thinking about whether a customer is obtaining substantially all of the remaining benefits from an asset in other Topics.



### Example 6.2.20

#### **Lease classification – present value test**

Lessee LE and Lessor LR enter into a lease of a truck. The following facts are relevant at the lease commencement date.

Non-cancellable lease term:	7 years
Lease payments:	Fixed payments of \$2,710 per year in arrears
Transfer of ownership:	No
Renewal/purchase options:	None
Fair value of truck:	\$28,272
Total economic life of truck:	20 years
Remaining economic life of truck:	10 years
LE’s incremental borrowing rate:	4.5% (implicit rate cannot be readily determined)

Initial direct costs:	None
RVG (lessee):	Guarantees residual value of \$14,545
Amount probable of being owed under RVG:	\$1,818
Present value of the lease payments + RVG:	\$26,657 = PV of the 'lease payments' of \$17,305 ( $\$2,710 \times 7$ ) + \$1,818 at end of Year 7, discounted at 4.5% + PV of the amount of the RVG not already included in the lease payments of \$9,352 (\$12,727 [\$14,545 – \$1,818] at end of Year 7, discounted at 4.5%)

In addition, LE evaluates lease classification using the bright-line thresholds – i.e. the 75%, 25%, and 90% thresholds for the lease term and present value tests (see paragraphs 6.2.90 and 6.2.110).

### Lease classification

LE classifies the lease as a **finance lease** based on the following.

- Transfer of ownership test – No
- Lessee purchase option test – N/A
- Lease term test – No (70%)
- Present value test – Yes (94%, or \$26,657 / \$28,272)
- Alternative use test – No



### Question 6.2.21

#### Lease classification – present value test in classification reassessment

### Should unamortized prepaid/accrued lease payments and unamortized lease incentives factor into the present value test when reassessing lease classification?

**Background:** Topic 842 requires lessees to reassess lease classification when either: [\[842-10-25-1\]](#)

- there is a change in the assessment of either (1) the lease term, or (2) whether it is reasonably certain that a lessee purchase option will be exercised (see section 6.6); or
- the contract that is or contains the separate lease component is modified and that modification is not accounted for as a separate contract (see section 6.7).

Classification is reassessed as of either:

- the lease term or purchase option reassessment date; or
- the effective date of the modification.

In practice, questions have arisen about what lease payments should be considered when performing the present value test as of the classification reassessment date. In particular, questions have arisen about situations where, immediately before the classification reassessment date, there is:

- a prepaid or accrued rent balance in the existing lease – e.g. arising from a significant prepayment or the straight-lining of lease cost in an operating lease (see paragraph 6.4.190); and/or
- an unamortized lease incentive.

**Interpretive response:** Yes. We believe prepaid and accrued rent, which includes the unamortized balance of lease prepayments, and unamortized lease incentives should be factored into the lease payments used in the present value test when reassessing lease classification.

### Prepaid rent

When a lease prepayment has been made before the classification reassessment date, the ‘lease payments’ (which include lease prepayments – see section 5.4) for the modified/remeasured lease to be included in the present value test include the unamortized amount thereof. [842-10-30-5(a)]

For example, Lessee has a 10-year lease for which it prepaid the \$100,000 in lease payments at lease commencement. When the lease is modified at the end of Year 3, the unamortized amount of the prepayment (\$70,000) is included in performing the present value test, together with any new lease payments required under the modified lease. It would not be appropriate to ignore the unamortized prepayment, and consider only the remaining post-modification lease payments, when assessing classification of the modified lease.

In addition to the extreme example in the preceding paragraph (i.e. a fully prepaid lease), a prepayment can arise solely from the timing of payments under the existing lease, or because the payments decrease over the lease term. However, although less significant than the unamortized prepayment in the prepaid lease example, we believe any prepaid rent balance resulting from these items would similarly be included in the lease payments of the modified or remeasured lease.

### Unamortized lease incentives

Like lease prepayments, lease incentives are part of the ‘lease payments’ (see section 5.4.3). [842-10-30-5(a)]

Therefore, we believe unamortized lease incentives should be treated in the same manner as unamortized lease prepayments when reassessing the classification of a modified or remeasured lease. This is even though unamortized lease incentives will have the opposite effect on the lease payments considered in the present value test – i.e. such amounts will reduce, rather than increase, the lease payments factored into the test by their inclusion.

### Accrued rent

Accrued rent will generally arise if a lease has escalating lease payments (e.g. \$100 in Year 1, \$110 in Year 2, \$120 in Year 3) or, less frequent, requires a balloon payment at or near the end of the lease. Accrued rent reflects the portion of the lease cost recognized to date attributable to lease payments the lessee has not yet made.

We believe it is appropriate to treat accrued rent in the same manner as prepaid rent. Consequently, we believe it is appropriate for the lessee to reduce the lease payments factored into the present value test by the amount of any

accrued rent. This will have the same effect on the lease payments considered in the present value test as unamortized lease incentives.

### Operational challenge

We are aware that some leasing IT systems have not been designed to separately track unamortized lease prepayments and lease incentives, or accrued rent after lease commencement. This is because those items become part of the measurement of the ROU asset (see paragraph 6.3.70), and many leasing IT systems have been programmed on the basis of 'Method 2' for measuring the ROU asset post-commencement (see paragraph 6.4.170).

Despite this operational challenge, we believe each of the items discussed in this question should be considered in the present value test when assessing the classification of a modified or remeasured lease. This is especially because Topic 842 describes subsequent measurement of the ROU asset in the manner of 'Method 1' (see paragraph 6.4.170), which involves separate tracking of prepaid/accrued rent and lease incentives, rather than Method 2.



### Question 6.2.25

#### Lease classification – portfolio residual value guarantee by the lessee

### How should a lessee evaluate the present value classification test when it provides a residual value guarantee of a portfolio of underlying assets?

**Background:** In some agreements, such as master lease agreements, a lessee may guarantee the residual value of a group of assets instead of the residual value of each individual asset in the group. For example, a lessee may guarantee that the combined residual value of five leased assets will be \$50,000 at the end of the lease of all five, without making any guarantee as to the residual value of any one of those five assets.

#### Residual value guarantees and lease classification

The principle in Topic 842 is to classify leases as finance or operating on the basis of whether the lease is akin to a financed purchase of the underlying asset by the lessee because the lessee, in effect, obtains control of (i.e. the ability to direct the use of, and obtain substantially all the remaining benefits from) the underlying asset through the lease. [IASU 2016-02.BC70](#)

The present value classification test includes the maximum amount of the lessee's residual value guarantee. This is because the lessee in effect controls that portion of the underlying asset that it has guaranteed – it has the choice to either (1) return the asset to the lessor with the required residual value, or (2) use and consume all or a portion of those benefits of the asset and pay the residual value deficiency. [IASU 2016-02.BC71\(d\)](#)

#### Guidance on lessor consideration of portfolio residual value guarantees

Topic 842 contains specific guidance applicable to lessors that residual value guarantees of a portfolio of underlying assets should generally be ignored when

performing the present value lease classification test (see paragraph 7.2.90 and Question 7.2.05).

However, Topic 842 does not state whether lessees should similarly ignore a portfolio residual value guarantee when performing the present value lease classification test for leases within the portfolio. [842-10-55-10]

**Interpretive response:** We believe that a lessee portfolio residual value guarantee should be factored into the lessee's consideration of the present value lease classification test for each lease within the portfolio to which the residual value guarantee applies.

Absent explicit guidance such as that for lessors stating portfolio residual value guarantees should be ignored when performing the present value lease classification test, we believe the basis for conclusions to ASU 2016-02 supports that lessee residual value guarantees (including those over a portfolio of underlying assets) should be considered.

#### How to consider the guarantee

Topic 842 does not address how a portfolio residual value guarantee should be allocated to the individual assets when assessing lease classification. In general, we believe an amount equal to the entire portfolio residual value guarantee should be assigned to *each* lease subject to the guarantee (referred to as the 'all-in' approach) when performing the present value lease classification test. This is because, by virtue of its unilateral right to choose which of the portfolio assets it can consume the remaining benefits of, the lessee effectively controls – i.e. has the right to direct the use, and obtain substantially all of the remaining benefits, of – all of the underlying assets.

However, in some cases, we believe it would also be acceptable for the lessee to allocate the portfolio residual value guarantee to the leases on a pro rata basis when performing the present value classification test. This would be acceptable when the leases associated with the portfolio residual value guarantee are substantially the same such that the lessee *could* (regardless of whether it does or does not actually do so) account for them on a portfolio basis (see section 5.8).

Under the pro rata approach, a portion of the portfolio residual value guarantee is allocated to each lease based on the expected residual value of each underlying asset at the end of the lease term. For example, if the total portfolio guarantee for a lease of five assets is \$50,000 and the expected residual value for each of the underlying assets is \$10,000, twenty percent of the total guarantee amount is allocated to each lease.

If a lessee elects to use the pro rata approach in those circumstances where it is permitted to do so, it should do so consistently.



### Example 6.2.25

#### **Lessee classification – present value test with lessee portfolio residual value guarantee**

Lessee LE and Lessor LR enter into four leases of identical pieces of equipment. The following facts are relevant for each lease at lease commencement (same date for all four leases).

Non-cancellable lease term:	7 years
Lease payments:	Fixed payments of \$2,710 per year in arrears
Transfer of ownership:	None
Renewal/purchase/termination options:	None
Fair value (FV) of equipment:	\$28,272
Total economic life of equipment:	20 years
Remaining economic life of equipment:	10 years
Alternative use to LR at end of lease:	Yes
Estimated residual value at end of lease:	\$11,000 per piece of equipment
LE's incremental borrowing rate:	4.5% (implicit rate cannot be readily determined)
Present value (PV) of lease payments:	\$15,969
Initial direct costs:	None

In addition, LE provides a guarantee that the residual value of the four pieces of equipment, in aggregate, will be \$44,000 at the end of the leases. There is no amount probable of being owed under the portfolio residual value guarantee at lease commencement. The leases are substantially similar (i.e. same term, same payments, identical underlying assets) such that LE could account for them using a portfolio approach.

Based on these facts, none of the finance lease criteria other than the present value test are met for any of the leases. LE evaluates the present value test using the bright-line threshold of 90% (see paragraph 6.2.110).

#### **Scenario 1: Present value test using all-in approach**

LE elects to use the all-in approach, even though LE would be permitted to use the pro rata approach. LE's application of the all-in approach to the present value test results in the following.

	Lease #1	Lease #2	Lease #3	Lease #4
FV of equipment:	\$28,272	\$28,272	\$28,272	\$28,272
PV of lease payments:	15,969	15,969	15,969	15,969
RVG amount:	44,000	44,000	44,000	44,000
PV of RVG amount: <sup>1</sup>	32,332	32,332	32,332	32,332
PV for classification test: <sup>2</sup>	48,301	48,301	48,301	48,301

	Lease #1	Lease #2	Lease #3	Lease #4
PV test met: <sup>3</sup>	Yes (171%)	Yes (171%)	Yes (171%)	Yes (171%)
Lease classification:	Finance	Finance	Finance	Finance
Notes:				
<ol style="list-style-type: none"> <li>Net PV of one payment equal to the 'RVG amount' to be paid at the end of the lease term, discounted using LE's incremental borrowing rate of 4.5%.</li> <li>PV of lease payments + PV of allocated RVG.</li> <li>PV for classification test / FV of equipment.</li> </ol>				

### Scenario 2: Present value test using pro rata approach

Because the leases could be accounted for using a portfolio approach, LE is permitted to use the pro rata approach to allocate the portfolio residual value guarantee for purposes of performing the present value test. LE's application of the pro rata approach to the present value test results in the following.

	Asset #1	Asset #2	Asset #3	Asset #4
Allocated RVG: <sup>1</sup>	\$11,000	\$11,000	\$11,000	\$11,000
PV of lease payments:	15,969	15,969	15,969	15,969
PV of allocated RVG: <sup>2</sup>	8,083	8,083	8,083	8,083
PV for classification test: <sup>3</sup>	24,052	24,052	24,052	24,052
PV test: <sup>4</sup>	No (85.1%)	No (85.1%)	No (85.1%)	No (85.1%)
Lease classification:	Operating	Operating	Operating	Operating
Notes:				
<ol style="list-style-type: none"> <li>\$44,000 total residual value guarantee × (\$11,000 estimated residual value for each piece of equipment / \$44,000 aggregate estimated residual value) = \$11,000.</li> <li>Net PV of one payment equal to the 'Allocated residual value guarantee' to be paid at the end of the lease term, discounted using LE's incremental borrowing rate of 4.5%.</li> <li>PV of lease payments + PV of allocated RVG.</li> <li>PV for classification test / FV of equipment.</li> </ol>				


**Question 6.2.26\*\***  
**Lease classification – applying the present value test to TRAC leases**

### How does a terminal rental adjustment clause affect the present value classification test?

**Background:** As discussed in Question 5.3.70, a terminal rental adjustment clause (TRAC) provides for a final rental payment adjustment at the end of the lease, often based on the amount realized by the lessor from sale of the vehicle compared to a depreciated book value. This can result in amounts being owed either by the lessor to the lessee or vice versa.

**Interpretive response:** The maximum amount of the lessee's residual value guarantee is factored into the present value classification test. In the context of a TRAC lease, this means that the maximum amount that the lessee could owe to the lessor as a final TRAC payment at the end of the lease term is required to be included in the present value calculation when evaluating lease classification. [842-10-25-2(d)]

By contrast, the 'lease payments' used to measure the lease liability include only the amount of any residual value guarantee that is 'probable' of being owed at the end of the lease (see section 5.4.6). Therefore, only the TRAC payment amount that is probable of being owed to the lessor at the end of the lease is factored into the measurement of the lease liability.

For example, assume at lease commencement the maximum amount the lessee could be required to pay to the lessor in satisfaction of the TRAC is \$5,000, but it is probable that the lessee will only owe \$1,000. In this case, the lessee includes the \$5,000 maximum possible payment when performing the present value classification test, but includes only \$1,000 in the lease payments amount when initially measuring the lease liability.

We do not believe that any expectation of a final adjustment payment owed to the lessee (i.e. a gain), even if probable, should be factored into either the present value classification test or the measurement of the lease liability. Instead, any potential payment owed to the lessee should be recorded by the lessee in the same manner as a contingent gain or negative variable lease payment, meaning it is recognized only when the gain is realized. [450-30-25-1]

6.2.140 When it is not practicable for an entity to determine the fair value of the underlying asset, lease classification is determined without consideration of the present value test. [842-10-55-3]

### **Alternative use test**

6.2.150 In assessing whether an underlying asset has an alternative use to the lessor at the end of the lease term, an entity considers the effect of contractual restrictions and practical limitations on the lessor's ability to readily direct the underlying asset for another use. [842-10-55-7]

- Contractual restrictions on a lessor's ability to redirect an asset must be substantive (i.e. enforceable) for the asset not to have an alternative use to the lessor.
- Practical limitations exist if the lessor would incur significant economic losses to direct the underlying asset for another use. A significant economic loss could arise because the lessor either would incur significant costs to rework the asset that exceed the economic benefits it would be able to derive from that rework, or would only be able to sell or re-lease the asset at a significant loss. This might occur, for example, with assets that have unique design specifications or that are located in remote areas.

6.2.160 The possibility of a contract with the lessee being terminated is not a relevant consideration for determining whether the lessor would be able to readily direct the underlying asset for another use. [842-10-55-7]

6.2.170 When an underlying asset has no alternative use to the lessor at the end of the lease term, the lessee consumes all (or substantially all) of the remaining benefits from the underlying asset. Absent significant rework or a change in circumstances during the lease term (e.g. the emergence of another potential customer or a new use for the underlying asset in its present, specialized form), there are no (or minimal) remaining benefits inherent in the underlying asset that revert to the lessor at the end of the lease term. Even if such a change in circumstances does occur during the lease term, classification of the lease is not reassessed. [IASU 2016-02.BC71(e)]



### Example 6.2.30

#### Lease classification – alternative use test

Lessor LR enters into a contract to customize a piece of production equipment for Lessee LE's specific needs and then to lease that equipment to LE for five years. At the end of five years, LR would incur significant costs to rework the design and functionality of the equipment to be able to lease or sell that equipment to another customer; it is unlikely that LR would be able to recover those costs.

The lease is classified as a finance lease by LE (and a sales-type lease by LR). This is regardless of the lease term, the lease payments, whether the lease includes a purchase option, and any other terms or conditions of the lease.



### Question 6.2.30

#### Contractual restrictions and the alternative use test

## How do contractual restrictions affect the alternative use test?

**Interpretive response:** Enforceable contractual restrictions on the lessor after the end of the lease term can affect whether the alternative use classification test is met. However, because the alternative use test explicitly applies only when the underlying asset is highly specialized or subject to highly specialized circumstances, we believe contractual restrictions alone (e.g. preventing the lessor from re-leasing or selling the asset to another customer) do not cause this test to be met if the underlying asset is not of a highly specialized nature or subject to highly specialized circumstances. [842-10-25-2(e), 55-7]

Contractual restrictions can affect the evaluation of the alternative use test because even a highly specialized asset may have an alternative use to the lessor at the end of the lease term; for example, there may be other customers, even if only a few, that could lease or purchase the asset.

A contractual restriction may be placed on the lessor if the lessee designed some of the specifications or paid the lessor a premium to develop or include those specifications in the asset; in that case, the lessee may require the restriction to prevent a competitor from benefitting from its investment in the

asset. If that contractual restriction is enforceable, even though the asset could be redirected for an alternative use, then this test would be met.



## Question 6.2.40 Asset evaluated for alternative use

**When evaluating whether the underlying asset has an alternative use to the lessor, should the asset be evaluated based on how it will be configured when it is ultimately returned to the lessor?**

**Interpretive response:** Yes. Consistent with a similar concept under Topic 606, we believe the alternative use of an asset should be assessed based on the configuration or form that will ultimately be returned to the lessor – e.g. after customization or modification.

Under Topic 606, when considering whether a good or service that will be transferred to the customer has an alternative use to the seller, the seller considers the characteristics of the asset that will ultimately be transferred to the customer and whether the asset – in its completed form – could be redirected without significant cost of rework. Therefore, this test can be met for an asset that only becomes customer-specific at or near the end of the production, modification or customization process. [IASU 2014-09.BC136, TRG 11-16.56](#)

The equivalent notion under Topic 842 is to consider the characteristics of the underlying asset that will ultimately be returned to the lessor at the end of the lease term. While lease classification is assessed at lease commencement, we believe the assessment considers all relevant expectations about customizations or modifications that will be made during the lease term, and that will affect the characteristics of the underlying asset at the point in time it is returned to the lessor.

For example, if there is an agreement for the lessor to make significant customizations after the commencement date that will result in the underlying asset not having an alternative use to the lessor at the end of the lease term, those should be considered at lease commencement when performing the alternative use test.

However, we believe consideration of the asset that will ultimately be returned to the lessor should not take into account customizations or modifications that are not already agreed or committed to at lease commencement. If significant customizations or modifications are made after lease commencement, that may result in a reassessment of the lease classification, among other things; this is because significant customizations or modifications to an underlying asset will generally trigger a reassessment of any lessee options in the contract (see section 6.6).



## Observation

### Alternative use test infrequently met on its own

6.2.180 The basis for conclusions states, "In general, it is expected that lessors would lease specialized assets that have no alternative use to them at the end of the lease term only under terms that would transfer substantially all the benefits (and risks) of the asset to the lessee (therefore, one of the other criteria for a finance lease also likely will be met)." [ASU 2016-02.BC71(e)]

6.2.190 We believe this statement is instructive in applying this new test for two reasons.

- It suggests that a conclusion that this test is met without meeting, or nearly meeting, any of the other accompanying tests may be worthy of further consideration; for example, when the lease term is almost a major part of the remaining economic life of the underlying asset, or the present value of lease payments is almost substantially all of the fair value of the underlying asset. That is not, however, to say it cannot be met in isolation.
- It emphasizes that this test is focused on capturing scenarios in which the lessor would have to perform significant rework on the underlying asset, or there would have to be a change in circumstances to redirect it for another use. This means that the underlying asset being of a highly specialized nature or subject to highly specialized circumstances (e.g. being located in a remote area) is, in fact, key to meeting this test. This test is not intended to be a second lease term test whereby it is met solely because the asset will have no alternative use at the end of the lease term because of its age.

## 6.2.2 Other classification considerations

### Lease of an acquiree

6.2.200 The acquirer retains the acquiree's lease classification, unless the lease is modified as part of the business combination and that modification is not accounted for as a separate contract (see section 6.7). [842-10-55-11]

### Related party leases

6.2.210 An entity classifies a lease between related parties on the basis of the legally enforceable terms and conditions of the lease. An entity does not classify the lease based on an evaluation of its economic substance. The classification and accounting for the leases should be the same as for leases between unrelated parties in the stand-alone financial statements of the related parties. [842-10-55-12]

6.2.215 An exception to paragraph 6.2.210 arises if the lease is between related parties under common control and the entity elects the practical expedient outlined in section 3.1.2. In that case, the entity classifies and accounts for the lease based solely on the written terms and conditions between the two parties. [842-10-15-3A]

 Question 6.2.50**Legally enforceable terms and conditions in common control leases****Do the 'legally enforceable terms and conditions' of a lease between entities under common control include terms that are outside of the written contract?**

*This question applies **only** to public companies, private entities before the adoption of ASU 2023-01 and private entities that do not elect the practical expedient in section 3.1.2.*

**Background:** Under Topic 842, an entity generally considers that the enforceable rights and obligations of two parties may extend beyond those written into the contract that contains the lease. This is because enforceability depends on the relevant laws and enforcement practices in the governing jurisdiction to which the contract is subject, and therefore can arise from other written agreements (outside of the contract that includes the lease), verbally or as a result of either entity's customary business practices. What rights and obligations are enforceable may vary across legal jurisdictions, industries and entities.

**Interpretive response:** Typically, no. While an entity should generally consider that the enforceable rights and obligations of the parties may extend beyond those written into the contract, in the case of a lease between parties under common control, we believe it was the Board's intent to significantly simplify the accounting for such leases by following easily identifiable terms and conditions. Identifying enforceable rights and obligations not included in a written contract may be extremely difficult in a lease between parties under common control because of the related party nature of the arrangement.

Therefore, while we acknowledge that looking only to the written terms of a lease between two parties under common control is inconsistent with looking to the enforceable rights and obligations of the entities more broadly in other scenarios, we believe this is consistent with the intent of the Board when establishing the related party leasing requirements in Topic 842.

[IASU 2016-02.BC374]

That said, if the written contract (including if there is no written contract) does not align with other related transactions or agreements – e.g. a one month written lease term but the lessee is constructing significant leasehold improvements with an economic life much longer than the written lease term – it should be considered whether there is an unwritten contract or understanding. Involvement of qualified legal counsel may be necessary to determine if an unwritten contract or understanding creates enforceable rights and obligations on the parties.

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**Facilities owned by a governmental unit or authority**

6.2.220 Because of special provisions normally present in leases of terminal space and other airport facilities owned by a governmental unit or authority, the economic life of such facilities for lease classification purposes is in effect

indeterminate. It also may not be practicable to determine the underlying asset's fair value. Accordingly, these leases are classified as operating leases if: [842-10-55-13]

- they do not transfer ownership of the underlying asset to the lessee by the end of the lease term; and
- it is not reasonably certain that the lessee will exercise an option (if there is one) to purchase the underlying asset.

6.2.230 This guidance also applies to leases of other facilities (e.g. ports and bus terminals), but only if all of the conditions in paragraph 842-10-55-13 are met.

6.2.240 Leases of underlying assets that do not meet all of those criteria are assessed using the same criteria for classifying leases that do not involve government-owned property. [842-10-55-14]

### ***Indemnification for environmental contamination***

6.2.250 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, does not affect lease classification. [842-10-55-15]



#### **Question 6.2.60**

#### **Lessee vs. lessor lease classification**

### **Will a finance lease of a lessee always be classified as a sales-type lease by a lessor?**

**Interpretive response:** No. While lessees and lessors apply the same criteria under Topic 842 to determine whether a lease is a finance lease (lessee) or a sales-type lease (lessor), there will be instances in which a finance lease is not classified as a sales-type lease or vice versa.

This may happen because of one or more of the following (not exhaustive).

- Differences in the discount rate used to determine the present value of the sum of the (1) lease payments and (2) residual value of the underlying asset – i.e. because the lessor will always use the rate implicit in the lease and the lessee will generally use its incremental borrowing rate (see section 5.6).
- Differences in judgments about the remaining economic life of the underlying asset, the fair value of the underlying asset and/or whether the underlying asset will have an alternative use to the lessor at the end of the lease term.
- Different assessments of lessee options to renew or terminate the lease or purchase the underlying asset.
- The payments for the lease are at least partially variable and sales-type classification by the lessor would give rise to a selling loss. In that case,

even if the lessee classifies the lease as a finance lease, the lessor is required to classify the lease as an operating lease (see paragraph 7.2.30).

Even if both the lessee and the lessor conclude the lease is not a finance/sales-type lease, different classification can result if the lessee concludes that the lease is an operating lease and the lessor concludes that the lease is a direct financing lease. Section 7.2 has further discussion of lease classification from the lessor's perspective.



## Comparison to legacy US GAAP

### Similar but not the same

6.2.260 While the lease classification tests in Topic 842 are similar to those in Topic 840, there may be differences in lease classification even when a lessee uses the bright-line thresholds – i.e. the 75%, 25% and 90% thresholds for the lease term and present value tests (see paragraphs 6.2.90 and 6.2.110). These differences arise from the following. [840-10-10-1, 25-1, 25-69]

- The alternative use test in Topic 842 did not exist under Topic 840.
- The exception that applies to the lease term test for leases that commence at or near the end of the underlying asset's economic life applied to both the lease term and the present value tests in Topic 840. Therefore, some leases that would have met the present value test under Topic 840 if it were not for the exception may meet that test, and be classified as a finance lease (or sales-type lease for lessors), under Topic 842.
- Most of the specific asset rules in Topic 840 (e.g. for the classification of a lease involving real estate) have not been carried forward to Topic 842. The only specific rule in Topic 840 carried forward is the exception to the lease term test when the lease commences at or near the end of the asset's economic life.
- There are other differences that are relevant for lessors that are discussed in section 7.2.

6.2.265 Some leases contain nonperformance-related default provisions that require the lessee to purchase the leased asset or make a lump sum payment if the lessee is in default. Under Topic 840, if any of four specified conditions were not met, the lessee was required to include the maximum possible amount it could be required to pay when performing the present value lease classification test. Therefore, the default provision might push a lease that would otherwise be classified as an operating lease into capital lease classification. [840-10-25-14]

6.2.266 The Topic 840 nonperformance-related default provisions guidance does not exist in Topic 842. Therefore, different present value test conclusions may be reached. However, despite having a less punitive effect on lease classification, entities should continue to identify and monitor these provisions as they may trigger changes to the lease payments or give rise to variable lease payments.

6.2.270 There are other changes reflected in Topic 842 that potentially could result in different lease classification compared with Topic 840, even if the lease classification tests were identical.

- Under Topic 842, 'executory costs' (e.g. lessor property tax and insurance costs paid or reimbursed by the lessee) are not excluded from the 'lease payments' used to perform the present value classification test. In contrast, those amounts were excluded from the minimum lease payments for purposes of performing the present value lease classification test in Topic 840. Therefore, because additional amounts may be included in the numerator of the present value test under Topic 842 as compared with the numerator of the present value test under Topic 840, more leases may be classified as finance leases (sales-type leases for lessors) under Topic 842.
- Lease payments under Topic 842 may be an allocated amount when there is more than one component of a contract (see section 4.4).

6.2.280 Finally, lease classification under Topic 840 was determined at lease inception, as opposed to lease commencement. [840-10-25-1]

## 6.3 Initial recognition and measurement (Step 5)



### Excerpt from ASC 842-20

#### 25 Recognition

##### General

**25-1** At the commencement date, a lessee shall recognize a right-of-use asset and a lease liability.

#### 30 Initial Measurement

##### General

**30-1** At the **commencement date**, a **lessee** shall measure both of the following:

- a. The lease liability at the present value of the lease payments not yet paid, discounted using the discount rate for the lease at lease commencement (as described in paragraphs 842-20-30-2 through 30-4)
- b. The right-of-use asset as described in paragraph 842-20-30-5.

> Discount Rate for the Lease

**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 instead of its incremental borrowing rate, determined using a period

comparable with that of the **lease term**, as an accounting policy election made by class of underlying asset.

**30-4** See Example 2 (paragraphs 842-20-55-17 through 55-20) for an illustration of the requirements on the discount rate.

> Initial Measurement of the Right-of-Use Asset

**30-5** At the **commencement date**, the cost of the **right-of-use asset** shall consist of all of the following:

- a. The amount of the initial measurement of the lease liability
- b. Any lease payments made to the lessor at or before the commencement date, minus any lease incentives received
- c. Any initial direct costs incurred by the lessee (as described in paragraphs 842-10-30-9 through 30-10).

**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**.

6.3.10 A lessee recognizes an ROU asset and a lease liability at lease commencement. [842-20-25-1]



### Observation

**Recognition or disclosure may be required before the commencement date**

6.3.20 The recognition of ROU assets and lease liabilities at the lease commencement date is consistent with the overall lease accounting model for lessees. A lessee recognizes a lease asset and a lease liability when it obtains control over the use of the underlying asset, which is at the lease commencement date (see section 5.1). [IASU 2016-02.BC182]

### Onerous lease contracts

6.3.30 A lease may be an onerous contract (e.g. the lease payments exceed the expected benefits to be derived from the lessee using the asset) between lease inception and lease commencement. In that case, the lessee accounts for the contract in accordance with Topic 450 (contingencies), which may require recognition of a liability before the lease commencement date.  
[ASU 2016-02.BC117, BC182]

### Disclosures about leases before recognition and measurement

6.3.40 In addition, as discussed in section 12.2, Topic 842 requires a lessee to disclose qualitative information about significant leases that have been entered into as of the reporting date, but which have not yet commenced. [842-20-50-3(b)]



### Question 6.3.10 **Capitalization thresholds**

**If adopting a policy not to capitalize leases below a specified threshold, does that threshold need to consider the effects of not recognizing the ROU asset, not recognizing the lease liability and not making the required disclosures about the lease separately?**

**Background:** In the basis for conclusions to ASU 2016-02, the Board observed that, in addition to accounting for some leases at a portfolio level, entities would likely be able to adopt reasonable capitalization thresholds below which lease assets and lease liabilities are not recognized; this should reduce the costs of applying the guidance. The Board noted that an entity's practice in this regard may be consistent with many entities' accounting policies in other areas of US GAAP – e.g. in capitalizing purchases of property, plant and equipment. [\[ASU 2016-02.BC122\]](#)

**Interpretive response:** Yes. Based on discussions with the SEC staff, we believe that while use of capitalization thresholds may be acceptable, like any other non-GAAP policy, a lessee should separately evaluate the effects of not recognizing the lease liability and the ROU asset on the balance sheet (both individually and in the aggregate) when establishing a capitalization threshold for leases. And, if the lessee also intends to exclude leases below the threshold from its lease disclosures, the threshold should consider the effect on the completeness and accuracy of those disclosures.

It would not be appropriate to:

- evaluate the effect of non-recognition on a 'net' basis – i.e. considering only the net effect on the balance sheet (ROU asset – lease liability);
- evaluate without consideration of the effect on disclosures; or
- default to a threshold used for another non-GAAP policy, such as that used for not capitalizing property, plant and equipment or prepaid expenses.

Because non-recognition of liabilities generally has a greater quantitative and qualitative effect on the financial statements than non-recognition of assets, we believe lease capitalization thresholds would typically need to be lower than those established for the capitalization of property, plant and equipment.

Depending on the facts and circumstances, consideration of the effect of excluding leases below the threshold from the lessee's lease disclosures may further lower the threshold.

Lessees may want to consider the materiality guidance in [SAB Topic 1.M](#) when considering an appropriate lease capitalization threshold.

#### **Non-recognition of ROU assets only**

While we expect most lessees' consideration of a capitalization threshold would relate to non-recognition of the entire lease (i.e. both the ROU asset and the lease liability) on its balance sheet, we believe it would be acceptable for a lessee to establish a threshold whereby it recognizes the lease liability, but does not recognize the ROU asset.

That is, for leases below the threshold, the lessee would expense at lease commencement an amount that would otherwise be the initial measurement of the ROU asset and account for the lease liability on an amortized cost basis, using the effective interest method, over the lease term. In that case, for operating leases, similar to when an ROU asset has been fully impaired (see section 6.5), we would expect the accretion of the lease liability to be presented as an operating expense, consistent with how the lessee's single lease cost would be presented if the ROU asset was recognized but impaired.

If a lessee adopts a capitalization threshold that applies only to its ROU assets, it may be able to use a threshold similar to that used for its owned property, plant and equipment because the considerations will generally be similar. However, the lessee's existing property, plant and equipment capitalization threshold that was deemed to be acceptable from a non-GAAP perspective will not have considered the incremental effect to the financial statements of the added non-recognition of ROU assets. Therefore, for the combined effect of not recognizing property, plant and equipment and ROU assets below the threshold to be immaterial, that threshold may need to be reconsidered.

In addition, consistent with the discussion of non-recognition of ROU assets and lease liabilities, the effect on the lease disclosures of expensing the ROU asset at lease commencement will need to be considered. The effect may be partially mitigated if:

- for operating leases, the lessee discloses the amount of expense recognized at lease commencement for the cost of the ROU asset and the accretion of the lease liability as operating lease cost in the disclosure required by paragraph 842-20-50-4(b); and
- for finance leases, the lessee discloses the amount of expense recognized at lease commencement for the cost of the ROU asset as ROU asset amortization in the disclosure required by paragraph 842-20-50-4(a).

6.3.50 At lease commencement, the lease liability for both finance and operating leases equals the present value of the unpaid lease payments, discounted at the rate implicit in the lease (if readily determinable), or otherwise at the lessee's incremental borrowing rate. The discount rate for the lease is calculated on the basis of information available at lease commencement. For a discussion on determining the 'lease payments', see section 5.4; and on determining the 'discount rate for the lease', see section 5.6. [842-20-30-1 – 30-3]



6.3.60 When the rate implicit in the lease is not readily determinable (see Question 5.6.20), a lessee that is not a public business entity may use a risk-free discount rate for the lease, instead of its incremental borrowing rate, as an accounting policy election by class of underlying asset. The risk-free rate is determined using a period comparable to that of the 'lease term'. [842-20-30-3]

6.3.70 The ROU asset for finance and operating leases is initially measured at the sum of: [842-20-30-5]



### Example 6.3.10

#### Initial measurement of the lease liability and ROU asset

Lessee LE enters into a contract with Lessor LR for the right to use office space for a 10-year term. The right to use the office space is a lease and there are no other components of the contract. The following facts are relevant at the lease commencement date.

Lease payments:	Fixed payments of \$14,527 per year in arrears, with a 3% increase every year after Year 1
Renewal options:	5-year extension; payments during that period are \$19,523 per year in arrears, with a 3% increase every year after Year 1 of the extended period
Termination/purchase options:	None
Transfer of ownership:	No
RVG:	None
LE's incremental borrowing rate:	10% (the rate implicit in the lease cannot be readily determined)
Initial direct costs (LE):	\$5,000

#### Contractual payments

For ease of reference in this example and Examples 6.4.10, 6.4.20, 6.5.10, 6.6.50, 6.7.10 and 6.7.30, the contractual payments for the right to use the office space are presented here.

#### Non-cancellable lease period

Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8	Yr 9	Yr 10	Total
\$14,527	\$14,963	\$15,412	\$15,874	\$16,350	\$16,841	\$17,346	\$17,866	\$18,402	\$18,954	\$166,535

#### Extension period

Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Total
\$19,523	\$20,109	\$20,712	\$21,333	\$21,973	\$103,650

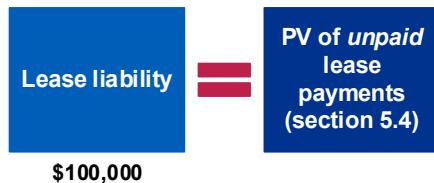
#### Lease payments

LE concludes, based on all relevant economic factors at the lease commencement date, that it does not have a compelling economic reason to exercise the extension option, and therefore is not reasonably certain to do so.

Therefore, the lease term is 10 years and the lease payments are the \$166,535 in payments that will be made during the 10-year lease term.

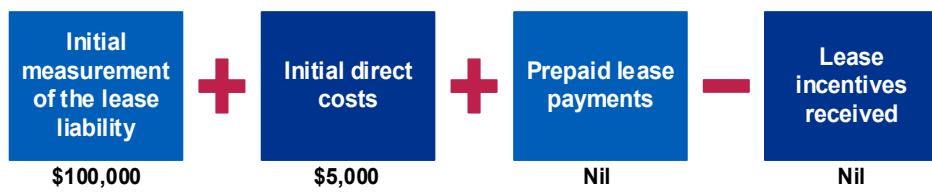
### Lease liability

At the lease commencement date, LE recognizes a lease liability of \$100,000. This is the present value of the 10 lease payments (starting at \$14,527 and escalating at 3% per year), discounted at LE's incremental borrowing rate of 10%.



### Right-of-use asset

LE recognizes a corresponding ROU asset of \$105,000, which is calculated as follows.




**Question 6.3.14**  
**Lease incentives receivable that exceed the unpaid 'lease payments' for a lease**

### How should a lessee account for lease incentives receivable from the lessor that exceed the unpaid lease payments?

**Background:** Paragraph 5.4.10 outlines that lease incentives reduce the 'lease payments'. Unpaid lease incentives (i.e. lease incentives receivable) reduce the recorded lease liability (see Example 5.4.90). [842-10-30-5(a)]

Lease incentives may be earned in leases with no, or only a minimal, recorded lease liability – e.g. in leases for which the payments for the right to use the underlying asset are mostly or entirely variable. Topic 842 does not address how a lessee should account for lease incentives whose recognition would reduce the carrying amount of the lease liability below zero.

**Interpretive response:** We believe the lessee should recognize the excess of the lease incentive receivable over the lease liability as a lease receivable.

In measuring the lease incentive receivable, we believe the lessee should discount the unpaid incentives using the discount rate for the lease (typically, the lessee's incremental borrowing rate – see Question 5.6.20). This is consistent with how the incentive payment inflows would be discounted if they

were netted against lease payment outflows in calculating the lease liability. We do not believe the lease incentive receivable should be discounted differently based solely on where it will be presented on the lessee's balance sheet.

Interest on the discounted lease incentive receivable should be recognized as a reduction of finance lease interest cost (finance leases) or operating lease cost (operating leases), which is consistent with how the interest element of a lease incentive receivable affects the lessee's income statement when the receivable is netted within a larger lease liability.

This guidance applies equally to contingent lease incentives (see Question 6.6.90), which may be recorded before they are received/receivable from the lessor if the lessee has elected the 'estimation at lease commencement' approach (see Question 6.6.80).

#### **Accounting for lease incentive receivables before lease commencement**

A lease incentive receivable may exceed the carrying amount of the lease liability because the incentive is earned before lease commencement – i.e. before a lease liability is recognized (see paragraph 6.3.10).

In that case, we believe a lease receivable should be recognized (consistent with the guidance above) together with an equal, offsetting lease incentive liability (see Question 6.3.15).

Because the discount rate for the lease is not determined until lease commencement, we believe the lessee should estimate the discount rate for the lease, and true up that rate at lease commencement; any resulting adjustment should be reflected equally in the initial measurement of the lease liability and the ROU asset. Interest on the receivable before lease commencement should be added to the carrying amount of the lease incentive liability.

At lease commencement, the carrying amount of the lease incentive receivable should be reclassified as a reduction of the lease liability to the extent it does not exceed it. See Question 6.3.15 for commencement date accounting for the lease incentive liability.



**Question 6.3.15**  
**Lease incentives that would result in a negative ROU asset**

#### **How should a lessee account for lease incentives that would result in a negative ROU asset?**

**Background:** As outlined in paragraph 6.3.70, lease incentives that have been received by the lessee on or before lease commencement are deducted from the initial carrying amount of the ROU asset. Lease incentives receivable (i.e. earned but not yet received) reduce the 'lease payments', and therefore both the lease liability and the ROU asset (see paragraph 5.4.10 and Example 5.4.90).

Consequently, lease incentives are recognized over the lease term as a reduction of ROU asset amortization (finance leases) or single lease cost (operating leases).

Topic 842 does not address how a lessee should account for lease incentives whose recognition would reduce the carrying amount of the ROU asset below zero. This might occur in a lease that either (1) has no recognized ROU asset (e.g. because all of the payments for the lease are variable), or (2) has an ROU asset with a carrying amount that is less than the lease incentive to be recorded – e.g. because most of the payments for the lease are variable or the ROU asset has been impaired.

**Interpretive response:** When a lease incentive has been received and the amount exceeds the carrying amount of the ROU asset, we believe the lessee should record the excess as a liability that is separate from the lease liability.

The liability should be amortized over the lease term, as a reduction of either finance lease ROU asset amortization or operating lease cost, generally on a straight-line basis. This is consistent with how the incentive would affect ROU asset amortization or operating lease cost were it recorded net within the ROU asset.

This guidance applies equally to contingent lease incentives (see Question 6.6.90), which may be recorded before they are received or become receivable from the lessor if the lessee has elected the ‘estimation at lease commencement’ approach (see Question 6.6.80).

#### Incentives earned before lease commencement

A lease incentive may exceed the carrying amount of the ROU asset because it is received or becomes receivable before lease commencement – i.e. before an ROU asset is recognized (see paragraph 6.3.10).

In that case, we believe a liability should be recognized consistent with the guidance in this question. That liability should be reclassified as a reduction of the ROU asset at lease commencement to the extent it does not exceed the ROU asset. The lease incentive liability should not be amortized before lease commencement.

Chapter 14 of KPMG Handbook, [Statement of cash flows](#), addresses the presentation of such incentives in the statement of cash flows.

### Question 6.3.17 Leases entered into for R&D purposes

#### How should leases be accounted for when entered into for R&D purposes and there is no alternative future use for the ROU asset?

**Interpretive response:** The accounting for the lease liability is unaffected by the fact that the lease was entered into for R&D purposes. The lease liability is accounted for in the same manner as for any other lease throughout the lease

term, including with respect to income statement presentation of the interest on a finance lease liability and accretion of an operating lease liability (see section 6.9).

We believe the appropriate accounting for the ROU asset depends on the classification of the lease as finance or operating.

### Finance leases

We believe the initial measurement of the ROU asset (see paragraph 6.3.70) should be expensed as an R&D cost at lease commencement.

When issuing Topic 842, the FASB concluded that a finance lease is economically similar to acquiring the underlying asset itself, and that there are substantial benefits to accounting for ROU assets consistently with other long-lived nonfinancial assets. Therefore, because Topic 730 requires expensing an item of PP&E if it is acquired for a particular R&D project and has no alternative future use, the same accounting should be applied to a finance lease ROU asset. [730-10-25-2(a), ASU 2016-02.BC57, BC255]

### Operating leases

For operating leases, in the absence of additional guidance from the FASB or from the SEC staff, we believe either of the following approaches is acceptable if applied consistently.

#### Approach A: Expense ROU asset at lease commencement

Similar to finance lease ROU assets, the initial measurement of the operating lease ROU asset (see paragraph 6.3.70) is expensed as an R&D cost at lease commencement.

The FASB did not equate *operating* leases to acquiring the underlying asset. However, the FASB's conclusion that there are substantial benefits to accounting for ROU assets consistently with other long-lived nonfinancial assets applies equally to finance and operating lease ROU assets. In addition, Topic 730 requires the expensing of intangible assets, which many consider operating lease ROU assets to be akin to, acquired for a particular R&D project and that have no alternative future use. [730-10-25-2(c), ASU 2016-02.BC57, BC255]

#### Approach B: Account for ROU asset like normal

Under this approach, the operating lease ROU asset is accounted for in the same manner as any non-R&D lease.

Supporters of this approach principally cite the FASB's stated intent not to change the income statement treatment of operating leases from legacy US GAAP (Topic 840). They observe that Approach A would reflect a significant change from how operating leases subject to this question were accounted for under Topic 840, under which lessees would recognize straight-line operating lease expense over the lease term even in R&D operating lease scenarios. [ASU 2016-02.Summary]

### Unrecognized short-term leases

If the lease is a short-term lease that the lessee does not recognize on-balance sheet, we believe the lessee should generally account for the lease in the same manner as a non-R&D short-term lease (see section 6.3.1).



## Comparison to legacy US GAAP

### Initial measurement

6.3.80 Under Topic 840, an entity initially measured a lease at lease inception – i.e. the date on which an agreement is reached, rather than at lease commencement.

6.3.90 In addition, Topic 840 precluded a lessee in a capital lease from measuring the asset recognized at an amount that was greater than the fair value of the underlying asset at lease inception. That requirement is not included in Topic 842. Consequently, the initial measurement of an ROU asset at the commencement date could potentially exceed the fair value of the underlying asset, although this outcome is unlikely. In such cases, a significant excess of initial carrying amount to fair value may indicate that the ROU asset or the asset group to which it belongs in accordance with Topic 360 (property, plant and equipment) is not recoverable. Section 6.5 discusses the testing of ROU assets for impairment. [840-30-30-1, 30-3]

6.3.100 Other differences could arise because the ‘lease payments’ under Topic 842 are not the same as the ‘minimum lease payments’ under Topic 840 (see section 5.4).

### 6.3.1 Short-term lease recognition exemption



#### Excerpt from ASC 842-20

##### 25 Recognition

###### General

> Short-Term Leases

**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.

**25-3** If the lease term or the assessment of a lessee option to purchase the underlying asset changes such that, after the change, the remaining lease term extends more than 12 months from the end of the previously determined lease term or the lessee is reasonably certain to exercise its option to purchase the underlying asset, the lease no longer meets the definition of a short-term lease and the lessee shall apply the remainder of the guidance in this Topic as if the date of the change in circumstances is the **commencement date**.

**25-4** See Example 1 (paragraphs 842-20-55-13 through 55-16) for an illustration of the requirements on short-term leases.

### 55 Implementation Guidance and Illustrations

#### General

- > Illustrations
  - > Illustration of a Short-Term Lease

**55-13** Example 1 illustrates the assessment of whether a lease is a short-term lease.

- • > Example 1—Short-Term Lease

**55-14** 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.

**55-15** 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.

**55-16** 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.

6.3.110 Although short-term leases are within the scope of Topic 842, a simplified form of accounting is permitted. A lessee can elect, by class of underlying asset, not to apply the recognition requirements of Topic 842 and instead to recognize the lease payments as lease cost on a straight-line basis over the lease term. This simplified accounting method is consistent with Topic 840 operating lease accounting. See Question 4.4.17 for changes to the election of a practical expedient, including the short-term lease recognition exemption. [842-20-25-2]



### Question 6.3.20

#### Applying the short-term lease exemption

#### Can the lease recognition exemption for short-term leases be applied to a lease whose term is just over 12 months?

**Background:** Entities may have administrative or other reasons (e.g. standard practice or tax reasons) that result in a lease term slightly greater than 12 months (e.g. 367 days). This may be the case even if the contract period is intended to approximate one year.

**Interpretive response:** No. The 12-month threshold for the short-term lease exemption is a bright-line exception to the lessee recognition requirements in

Topic 842. As with other exceptions in the accounting literature, it is applied narrowly as written in Topic 842. Consequently, leases whose terms extend beyond one year, no matter by how much (even one day), are not eligible for the short-term lease recognition exemption.

### Question 6.3.21

#### Short-term lease recognition exemption – subsequent consideration

### Can a lease that was not eligible for the short-term lease exemption at lease commencement subsequently qualify for the exemption?

**Background:** A lease may be modified or the lease term reassessed after lease commencement such that the reassessed lease term is 12 months or less. Similarly, a lessee purchase option that precluded short-term lease categorization because it was assessed as reasonably certain to be exercised may be (1) removed via modification or (2) reassessed.

**Interpretive response:** No. The determination about whether a lease meets the definition of a 'short-term lease' is made at lease commencement. This is because the definition of a short-term lease is one that has a lease term of 12 months or less 'at the commencement date'. [\[842 Glossary\]](#)

Topic 842 has specific guidance overriding the definition, requiring on-balance sheet recognition regardless of the determination made at lease commencement, when (see paragraph 6.3.130): [\[842-20-25-3\]](#)

- the lease term changes such that the remaining lease term extends more than 12 months from the end of the previously determined lease term; or
- it becomes reasonably certain that the lessee will exercise a purchase option.

However, no similar override exists for changes going in the opposite direction. Therefore, a lease that is not a short-term lease at lease commencement can never subsequently be eligible for the short-term lease recognition exemption.

### Question 6.3.30

#### Residual value guarantees in short-term leases

### Does a lessee recognize a separate liability for amounts probable of being owed under a residual value guarantee for a short-term lease to which the recognition exemption is applied?

**Background:** Under legacy US GAAP, a lessee residual value guarantee of an underlying asset subject to an operating lease was accounted for in accordance with Topic 460 (guarantees). The lessee-guarantor recognized the fair value of

the guarantee based on the fair value of the guarantee at lease inception, even if no residual value deficiency was probable. An illustration in Topic 460 indicated that the guarantee liability recognized by the lessee should be accounted for as prepaid rent and, therefore, amortized on a straight-line basis over the term of the lease. [840-20-30-1, 35-1, 460-10-15-7(b), 30-2(b), 55-23(d)]

Subsequent accounting for the guarantee liability after recognition followed the guidance in Topic 460.

**Interpretive response:** Yes, to the extent that a residual value deficiency is probable and estimable – i.e. the liability recognition requirements in Topic 450 are met. [450-20-25-2]

If no deficiency is probable and estimable, we do not believe a liability should be recognized. This is because, as a result of an amendment to Topic 460 in ASU 2016-02, all lessee guarantees of the residual value of an underlying asset at the end of the lease term are excluded from the scope of Topic 460 – i.e. there is no exception to that scoping provision for unrecognized short-term leases. [460-10-15-7(b)]

If a residual value deficiency is probable and estimable, we believe either of the following approaches is appropriate.

- **Recognize the liability immediately.** Under this approach, there is an offset to prepaid rent, which is amortized on a straight-line basis over the remainder of the lease term. This approach is broadly consistent with adding probable residual value deficiencies for recognized operating or finance leases to the lease liability and the ROU asset (albeit, in this case, at an undiscounted amount).
- **Accrue the cost over the lease term.** Under this approach, the residual value deficiency is an incremental lease payment, recognized on a straight-line basis over the remainder of the lease term so that the expected liability is fully accrued by the time satisfaction of the residual value deficiency is required. This approach is consistent with the Board's intent for lessees to account for unrecognized short-term leases in a manner consistent with Topic 840 operating lease accounting because it is consistent with the legacy requirements in Topic 840 for when a residual value deficiency becomes probable in an operating lease.

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6.3.120 The lease term and the lease payments are determined in a manner consistent with all other leases (see sections 5.3 and 5.4). Consequently, the short-term lease exemption may be applied to cancellable leases (e.g. month-to-month, evergreen and at-will leases) if the lessee is not reasonably certain to renew (or to continue, in the case of a termination option) the lease beyond 12 months. [842-20-25-2]



### Example 6.3.20

#### Is it a short-term lease?

##### **Scenario 1: Lease meets the definition of a short-term lease**

Lessee LE enters into a contract with Lessor LR to lease a piece of non-specialized equipment for 12 months for construction work at one of its factories. The following facts are relevant at lease commencement.

Lease payments:	Fixed payments of \$500 per month in arrears, with a 3% increase every month after Month 1
Renewal options:	Two 12-month extensions, with no change in payment structure
Termination options:	None
Purchase option:	Option to purchase at then-prevailing fair value at any time during the lease

At lease commencement, LE determines it is not reasonably certain to exercise the renewal options or the purchase option considering all relevant economic factors (i.e. based on the renewal lease payments or the purchase option exercise price), and the nature of the underlying asset as a non-specialized asset with readily available equivalents in the marketplace.

Therefore, the lease is a short-term lease because the lease term is not more than 12 months and LE is not reasonably certain to exercise the purchase option in the contract.

LE has not already elected an accounting policy for short-term leases. Upon entering into this lease, LE elects to apply the short-term lease exemption to all short-term leases of assets within the same class of underlying asset. Going forward, LE will be required to apply the exemption for all other short-term leases of that class of underlying asset.

In applying the short-term lease exemption, LE recognizes the lease payments as lease cost on a straight-line basis over the lease term.

##### **Scenario 2: Short-term lease that still meets the definition after a reassessment**

Continuing from Scenario 1, three months after entering into the lease, Lessee LE expands the scope and duration of construction at its factory so that it is now reasonably certain to exercise the first renewal option for the equipment. The equipment is installed at the factory such that it would be cost-prohibitive to remove and install a replacement piece of equipment to complete the construction work.

The lease continues to qualify as a short-term lease, because the remaining lease term after the reassessment does not extend more than 12 months from the end of the previously determined lease term.

However, if the renewal period had been for 13 months instead of 12, the lease would no longer have qualified as a short-term lease and LE would have been required to apply the requirements of Topic 842 as if the date of the change in assessment of the renewal option were the commencement date. In that case, LE would have recognized and measured at the end of Month 3 a lease

liability and an ROU asset for the equipment lease (reflecting a lease term of 22 months).

### Scenario 3: Lease does not meet the definition of a short-term lease

Lessee LE enters into a contract with Lessor LR to lease a car. The lease term is nine months and LE has the option to renew the lease for another six months. At lease commencement, LE is reasonably certain to exercise the renewal option.

The lease does not meet the definition of a short-term lease because the lease term is 15 months.



### Example 6.3.30

#### Leases with termination options

### Scenario 1: Termination option controlled by lessor

Lessee LE enters into a contract with Lessor LR to lease a jackhammer. The lease is for 10 months and will be automatically renewed for a further 6 months unless the lease is terminated by LR.

Periods covered by an option to extend (or not to terminate) the lease where exercise of the option is controlled by the lessor are included in the lease term (see section 5.3). Accordingly, the lease term is 16 months. Therefore, the lease does not meet the definition of a short-term lease because the lease term is more than 12 months.

### Scenario 2: Termination option controlled by lessee

Assume the same facts as in Scenario 1, except that the decision about whether to terminate the lease after 10 months is Lessee LE's (rather than Lessor LR's). At lease commencement, LE is not reasonably certain to continue the lease beyond the 10-month non-cancellable term based on all relevant economic factors.

The lease term is 10 months. Therefore, the lease meets the definition of a short-term lease because the lease term is not more than 12 months.

6.3.130 When the assessment of the lease term or a lessee purchase option changes due to a reassessment or modification (see sections 6.6 and 6.7, respectively) such that the remaining lease term extends more than 12 months from the end of the previously determined lease term, or it becomes reasonably certain that the lessee will exercise a purchase option, the lease no longer qualifies for the recognition exemption. In that case, the lessee applies the requirements of Topic 842, including the recognition and measurement requirements, as if the date of the change were the commencement date of the lease. [842-20-25-3]



### Question 6.3.40

#### Reassessment of short-term leases

### Are the lease term or purchase option reassessment requirements for short-term leases different from those for leases that are not short-term?

**Interpretive response:** No. The requirements for when and how to undertake a reassessment of the lease term or a lessee purchase option for a short-term lease are the same as for all other leases (see section 6.6).

6.3.140 A lessee is required to disclose each period its lease cost for short-term leases for which it elects the recognition exemption, excluding expenses relating to leases with a lease term of one month or less. [842-20-50-4(c)]

6.3.150 A lessee applying the short-term lease exemption to a class of underlying assets for which it has short-term leases discloses that fact. In addition, if the short-term lease cost for the period is not representative of the lessee's short-term lease commitments, the lessee discloses that fact, and the amount of its short-term lease commitments (see section 12.2). [842-20-50-8]



### Question 6.3.50

#### Low-value assets lease exemption

### Does Topic 842 include an exemption for low-value assets?

**Interpretive response:** No. Topic 842 does not include an exemption for leases of low-value assets such as some copiers, some computer and personal IT equipment, or office furniture. This is a notable difference compared to lease accounting under IFRS 16.

Under IFRS 16, a lessee is permitted not to apply the recognition and measurement requirements to leases of assets that are of 'low value', which the basis for conclusions to IFRS 16 suggests are assets with a value of \$5,000 or less when new. The lessee accounts for such qualifying leases consistent with IAS 17 operating lease accounting. This US GAAP/IFRS Accounting Standards difference may complicate the comparison of financial statements of some entities reporting under US GAAP and IFRS Accounting Standards, given the Board's decision not to provide a similar exemption. [IFRS 16.5(b), IFRS 16.BC100, ASU 2016-02.BC421]

The Board decided against a low-value asset exemption because current guidance on materiality permits a lessee to exclude leases that are immaterial to its financial statements. The Board observed that a lessee may be able to adopt reasonable capitalization thresholds below which lease assets and lease liabilities are not recognized, consistent with capitalization thresholds currently used by some entities in other areas of US GAAP (e.g. for capitalizing purchases of property, plant or equipment). See Question 6.3.10.



## Observation

### **Short-term lease exemption may not create significant structuring opportunities**

6.3.160 The Board considered the possibility of leases being structured to meet the definition of a short-term lease. However, there are economic considerations that are likely to affect the appetite that both the lessee and the lessor have to structure short-term leases. For example, lessors who enter into short-term leases will take on more residual asset risk, and therefore may require increased lease payments to mitigate that risk. Other lessors may refuse to take on that additional risk entirely or be unable to do so based on the terms of their financing arrangements to acquire the leased assets.

[ASU 2016-02.BC381]

### **Additional accounting considerations for short-term leases**

6.3.170 For leases with a non-cancellable period of 12 months or less that include renewal options (including options not to terminate the lease) and/or purchase options, the 'reasonably certain' assessment (see section 5.2) will, in effect, become the on/off-balance sheet test if the lessee elects the short-term lease exemption. Therefore, lessees with leases of that nature that elect the exemption will need to have processes and controls in place to ensure that the exemption is applied appropriately and, because the exemption is an accounting policy election, is applied consistently to all similar leases.

6.3.180 In addition, the specific disclosure requirements applicable to short-term leases mean that lessees will need processes and controls in place to accumulate and maintain the information necessary to comply with those disclosure requirements. This includes processes to differentiate short-term leases (i.e. those with a lease term of 12 months or less) from very short-term leases (i.e. those with a lease term of one month or less), the costs of which are not disclosed in the short-term lease cost disclosure. The disclosures are discussed in section 12.2.



## Comparison to legacy US GAAP

### **Short-term lease exemption not relevant under Topic 840**

6.3.190 There is a possibility (albeit remote) that some leases that were classified as capital leases under Topic 840 may qualify for the short-term lease exemption, and therefore be derecognized as a result of the short-term lease exemption. However, the exemption is most likely to apply to current operating leases, which are not required to be recognized on-balance sheet currently.

### **Similar disclosure requirements**

6.3.200 Topic 840 required lessees to disclose rental expense for all leases with a lease term of more than one month. Therefore, the requirement to disclose short-term lease cost for all such leases with a term greater than one month is not incremental to the Topic 840 disclosure requirements. However, the requirement to disclose short-term lease cost each period separately from other

lease costs (e.g. operating lease cost and variable lease cost) may involve some incremental effort. [840-20-50-1]

## 6.4 Subsequent accounting (Step 6)



### Excerpt from ASC 842-20

#### 25 Recognition

##### General

> Finance Leases

**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.

> Operating Leases

**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 Subsequent Measurement**

#### **General**

**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.

**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.

> Amortization of the Right-of-Use Asset for a Finance Lease

**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.

> Amortization of Leasehold Improvements

**35-12** Leasehold improvements, other than those accounted for in accordance with paragraph 842-20-35-12A, 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.

**35-12A** Leasehold improvements associated with a lease between entities under common control shall be:

- a. Amortized over the useful life of those improvements to the common control group as long as the lessee controls the use of the underlying asset through a lease. If the **lessor** obtained the right to control the use of the underlying asset through a lease with another entity not within the same common control group, the amortization period shall not exceed the amortization period of the common control group determined in accordance with paragraph 842-20-35-12.
- b. Accounted for as a transfer between entities under common control through an adjustment to equity (net assets for a **not-for-profit entity**) when the lessee no longer controls the use of the underlying asset.

**35-12B** An entity with leasehold improvements accounted for in accordance with paragraph 842-20-35-12A shall apply the impairment requirements in paragraph 360-10-40-4, considering the useful life to the common control group.

**35-12C** If after the **commencement date** the lessee and lessor become within the same common control group or are no longer within the same common control group, any change in the required amortization period for leasehold improvements shall be accounted for prospectively as a **change in accounting estimate** in accordance with paragraph 250-10-45-17.

**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.

## 55 Implementation Guidance and Illustrations

### General

- > Implementation Guidance
- > Recognition of Costs from Variable Lease Payments

**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.

- > Pattern of Benefit from Use of the Underlying 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.

- > Maintenance Deposits

**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 Denominated in a Foreign Currency

**55-10** The **right-of-use asset** is a nonmonetary asset while the **lease liability** is a **monetary liability**. Therefore, in accordance with Subtopic 830-10 on foreign currency matters, when accounting for a **lease** that is denominated in a foreign currency, if remeasurement into the **lessee's** functional currency is required, the lease liability is remeasured using the current exchange rate, while the right-of-use asset is remeasured using the exchange rate as of the **commencement date**.

- > Illustrations

- > Illustrations of Lessee Recognition and Measurement in an Operating Lease

**55-40** 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.

- • > 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.

## 6.4.1 Finance leases

6.4.10 After lease commencement, a lessee measures the lease liability on an amortized cost basis. The lease liability is increased to reflect interest on the liability and decreased to reflect the lease payments made during the period. [\[842-20-35-1\(a\)\]](#)

6.4.20 Interest on the lease liability is determined each period during the lease term as the amount that results in a constant periodic discount rate on the remaining balance of the liability. [\[842-20-35-1\(a\)\]](#)

6.4.30 After lease commencement, a lessee measures the ROU asset at cost, less accumulated amortization and any accumulated impairment losses (see section 6.5). [842-20-35-1(b)]



6.4.40 A lessee amortizes the ROU asset on a straight-line basis, unless another systematic basis is more representative of the pattern in which the lessee expects to consume the future economic benefits of the ROU asset. After an impairment, amortization is generally on a straight-line basis based on the carrying amount of the ROU asset following the impairment. [842-20-35-7]

6.4.50 In general, amortization of the ROU asset is recognized over the period from the commencement date to the earlier of (1) the end of the useful life of the ROU asset, or (2) the end of the lease term. However, if the lease transfers ownership of the underlying asset to the lessee or the lessee is reasonably certain to exercise a purchase option to acquire the underlying asset, the lessee amortizes the ROU asset to the end of the underlying asset's useful life. [842-20-35-8]

6.4.60 In addition to amortization of the ROU asset and interest on the lease liability, a lessee will recognize the following lease costs: variable lease payments excluded from initial measurement (see section 5.4) and any impairment of the ROU asset (see section 6.5). The relevant costs are included in the income statement each period of the lease term unless they are included in the carrying amount of another asset in accordance with other US GAAP (which excludes any impairment charges, which cannot be capitalized as part of the cost of another asset). For example, when an entity leases equipment that will be used to produce inventory, all or a portion of the equipment lease cost would typically be included in the cost of the inventory. [842-20-25-5, 360-10-45-4]



### Observation

#### **Focus on lease costs rather than lease expense**

6.4.70 The guidance in Topic 842 refers to lease costs (for finance and operating leases) potentially being included in the carrying amount of another asset in accordance with other US GAAP. Consistent with Topic 840, some or all of the cost of a lease may be capitalized as part of the cost of another asset – e.g. an item of property, plant or equipment or an item of inventory. [842-20-25-5, 25-6]

6.4.80 This focus on lease cost, rather than lease expense, has been carried forward to the lessee disclosure requirements (see section 12.2) to ensure that financial statement users have a more complete picture of a lessee's leasing activity. The Board concluded that the adjustments made by many financial statement users would be based on incomplete information if the quantitative disclosures were based on amounts recognized as lease expense in the income statement rather than total lease cost.

6.4.90 For variable lease payments based on the achievement of a specified target, a lessee recognizes the costs in annual periods and in interim periods before the achievement of the specified target that triggers the variable lease payments to the extent the achievement of that target is considered probable. Variable lease costs recognized are reversed if it becomes probable that the specified target will not be met. This means that the cumulative amount of variable lease cost recognized at any point in time during the lease term will be the amount of variable lease payments that are either paid (and nonrefundable) or probable of being paid. [842-20-55-1 – 55-2]



### Example 6.4.10

#### Subsequent measurement of a finance lease

In Example 6.3.10, Lessee LE recognized a lease liability of \$100,000 and an ROU asset of \$105,000 for its lease of office space with Lessor LR. Assume that the lease is actually of a piece of equipment (rather than office space), and the following facts are changed from Example 6.3.10.

Remaining economic life of equipment:	12 years
Renewal options:	None

LE classifies the lease as a finance lease. This is based on the lease term test: 10/12 years equals 83% of the remaining economic life of the equipment (see paragraph 6.2.50).

LE expects to consume the ROU asset's future economic benefits evenly over the lease term. Accordingly, LE amortizes the ROU asset on a straight-line basis over 10 years.

During the lease term, LE will account for the lease liability and the ROU asset as follows (assuming no remeasurements, modifications or impairments).

Year	Lease liability				ROU asset		
	Beg. balance	Interest	Pmts.	End. balance	Beg. balance	Amort.	End. balance
1	\$100,000	\$10,000	\$(14,527)	\$95,473	\$105,000	\$(10,500)	\$94,500
2	95,473	9,547	(14,963)	90,057	94,500	(10,500)	84,000
3	90,057	9,006	(15,412)	83,651	84,000	(10,500)	73,500
4	83,651	8,365	(15,874)	76,142	73,500	(10,500)	63,000
5	76,142	7,614	(16,350)	67,406	63,000	(10,500)	52,500
6	67,406	6,741	(16,841)	57,306	52,500	(10,500)	42,000
7	57,306	5,731	(17,346)	45,691	42,000	(10,500)	31,500
8	45,691	4,569	(17,866)	32,394	31,500	(10,500)	21,000
9	32,394	3,239	(18,402)	17,231	21,000	(10,500)	10,500
10	17,231	1,723	(18,954)	-	10,500	(10,500)	-

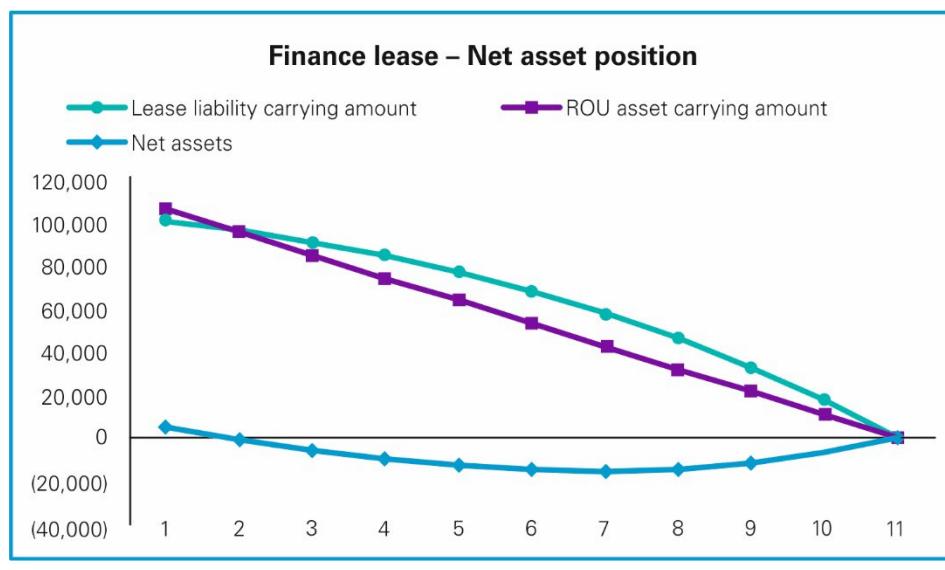


## Observation

### Negative net asset position for most finance leases

6.4.100 The subsequent measurement guidance in Topic 842 for finance leases will generally result in a negative net asset position for the lessee (in leases with no prepaid rent) throughout the lease term other than at lease commencement and at the end of the lease term (assuming a straight-line basis of amortization for finance lease ROU assets). The finance lease amortization model results in a balance sheet effect that is generally consistent with the effect that assets entirely acquired with debt financing have on the balance sheet.

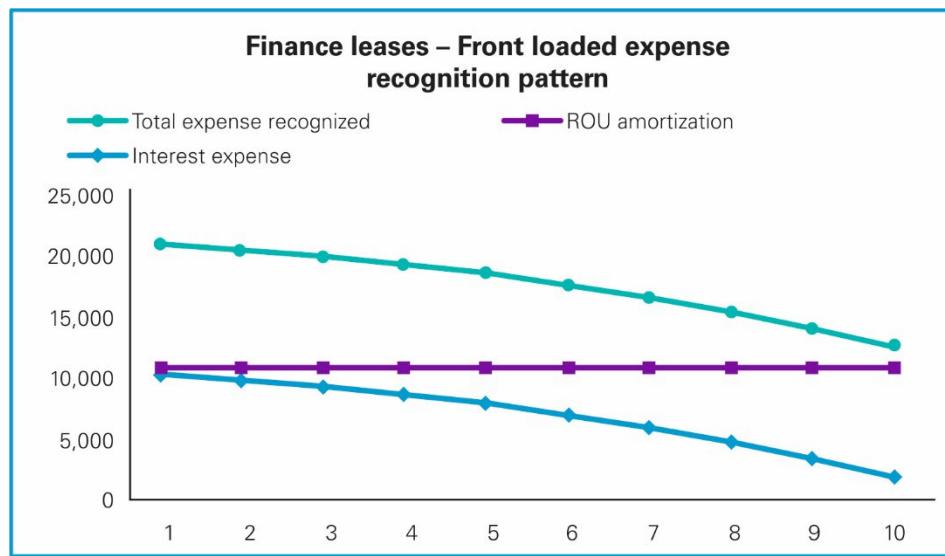
6.4.110 The following chart illustrates these effects for lessees using the fact pattern in Example 6.4.10.



## Observation

### Front-loaded pattern of lease expense recognition for finance leases

6.4.120 Because the ROU asset is generally amortized on a straight-line basis while interest is calculated on the lease liability using the effective interest method, finance leases will generally result in a front-loaded pattern of total expense recognition. This is illustrated in the following chart using the fact pattern in Example 6.4.10.



### Comparison to legacy US GAAP

#### Important differences between finance lease accounting and capital lease accounting

6.4.130 As outlined in chapters 4 and 5, there are important separation/allocation model differences (e.g. allocation of certain executory costs) and definitional differences (e.g. 'lease payments' in Topic 842 versus 'minimum lease payments' in Topic 840) that mean the accounting for a finance lease under Topic 842 will often differ from the accounting for a capital lease under Topic 840.

6.4.140 In addition, while the guidance about how to amortize the ROU asset and accrete the lease liability in a finance lease is substantially the same as that applicable to capital leases in Topic 840, the subsequent accounting for a finance lease will differ substantially from a capital lease in the following ways.

- Having to monitor for reassessment events; for example, a significant event requiring a reassessment of the lease term or a change in the amount probable of being owed under a residual value guarantee (see paragraph 6.6.10).
- Having to remeasure the lease liability (and ROU asset) if a reassessment event occurs (see paragraph 6.6.140).
- The accounting for modifications to a finance lease (see section 6.7).

## 6.4.2 Operating leases

6.4.150 After lease commencement, a lessee measures the lease liability at the present value of the unpaid lease payments discounted at the discount rate for

the lease established at the commencement date. An exception to this general principle occurs when the rate is updated as a result of a lease remeasurement (see section 6.6) or lease modification (see section 6.7). [842-20-35-3(a)]

6.4.160 Although Topic 842 describes the subsequent measurement of an operating lease liability differently from a finance lease liability, the carrying amount of the lease liability throughout the lease term is not affected by the classification of the lease. The carrying amount will equal the present value of the remaining, unpaid lease payments throughout the lease term.

6.4.170 After lease commencement, unless the ROU asset has been impaired (see section 6.5), the carrying amount of an operating lease ROU asset can be determined in either one of two ways, which each produce the same carrying amount of the ROU asset throughout the lease term.

- **Method 1:** The carrying amount of the ROU asset is derived from the carrying amount of the lease liability at the end of each reporting period – i.e. a lessee measures the ROU asset as follows. [842-20-35-3(b)]



- **Method 2:** Amortize the ROU asset, calculated as the difference between the straight line lease cost for the period (including amortization of initial direct costs) – see paragraph 6.4.190 – and the periodic accretion of the lease liability using the effective interest method.



6.4.180 Paragraph 6.5.40 describes how to measure an ROU asset after it has been impaired in accordance with Topic 360.

6.4.185 Questions 6.3.14 and 6.3.15 outline how to account for lease incentives that exceed the carrying amount of the lease liability and ROU asset immediately before the incentive is received, respectively.



### Question 6.4.10

#### Choice of subsequent measurement methods for operating lease ROU assets

**Is a lessee's selection of the method to subsequently measure operating lease ROU assets an accounting policy election that must be used for all of the lessee's operating leases?**

**Interpretive response:** No. The lessee's decision to use Method 1 or Method 2 in paragraph 6.4.170 has no effect on the measurement of the ROU asset at any point during the lease term – i.e. the measurement of the ROU asset will be the same regardless of which method is applied.

The question of which method to use, and whether to use it for all or only some of the entity's leases, is principally an operational one for lessees. While we believe most entities will choose to use only one method for all their leases, there will be more considerations that come into play when deciding which method to use.

#### Deciding between Method 1 and Method 2

Sometimes referred to as the 'display approach', Method 1 is the only method described in Topic 842. The basis for conclusions indicates the Board's view that this method will permit many entities to perform the new accounting for operating leases without significant changes to systems or processes. In general, Method 1 is what a lessee would be more likely to use if it does not want to recognize ROU assets and lease liabilities for operating leases until it closes its books during the financial reporting process.

Under this method, rather than maintain ROU assets and lease liabilities in its general ledger, at each reporting date, the lessee creates a journal entry to (1) credit a lease liability for the present value of the remaining unpaid lease payments, (2) reverse other accrual-based operating lease accounting balances reflected on the balance sheet (i.e. prepaid or accrued rent, unamortized initial direct costs and unamortized lease incentives) and (3) debit an ROU asset for the balancing amount.

Method 1 may not be practicable for entities other than those with a smaller volume of leases that are relatively straightforward. Method 1 is inherently a manual process that likely will be unwieldy when applied to a large portfolio of leases, especially in the context of the more complex circumstances that will arise under the guidance in Topic 842 – e.g. modifications, remeasurements, impairments and foreign currency translation adjustments.

We believe Method 2 will more readily enable a lessee to implement systems, processes and controls where lease liabilities and ROU assets are tracked separately in a manner more consistent with other assets and liabilities. It is more likely to be effective for addressing the more complex circumstances outlined above that are likely to arise for many lessees. For leases denominated in a foreign currency, Method 1 may not be practicable because of the different foreign exchange rates required to be used in relation to the (1) measurement and amortization of the ROU asset and (2) measurement and accretion of the lease liability (see paragraph 6.4.240 and Question 6.4.20).

6.4.190 After the lease commencement date, a lessee recognizes the following amounts in the income statement – except to the extent that the costs are included in the carrying amount of another asset in accordance with other US GAAP.

- **A single lease cost**, calculated so that the remaining cost of the lease is allocated over the remaining lease term on a straight-line basis (if another systematic and rational basis is not more representative of the benefit expected to be derived from the right to use the underlying asset), unless the ROU asset has been impaired (see section 6.5). [842-20-25-6, 25-8]



Notes:

1. Paid and unpaid, reflecting any adjustments resulting from a remeasurement (see section 6.6) or a modification (see section 6.7).
2. Those attributable to that lease.
3. The total amount of lease cost recognized (including capitalized as part of the cost of another asset) for the lease in prior periods.

- **Variable lease payments** in the period in which the obligation is incurred, or achievement of the target that triggers the variable payments becomes probable (see paragraph 6.4.200).
- Any **impairment** of the ROU asset (see section 6.5).

6.4.200 For variable lease payments based on the achievement of a specified target, a lessee recognizes the costs in annual periods and in interim periods before the achievement of the specified target that triggers the variable lease payments, to the extent the achievement of that target is considered probable. Variable lease costs recognized are reversed if it is probable that the specified target will not be met. This means that the cumulative amount of variable lease cost recognized at any point in time during the lease term will be the amount of variable lease payments that are either paid (and nonrefundable) or probable of being paid. [842-20-55-1 – 55-2]



### Example 6.4.20

#### **Subsequent accounting for an operating lease – assuming no impairments, remeasurements or lease modifications**

##### **Scenario 1: Subsequent measurement using Method 1**

In Example 6.3.10, Lessee LE recognized a lease liability of \$100,000 and an ROU asset of \$105,000 for its lease of office space with Lessor LR.

The following facts in addition to those in Example 6.3.10 are relevant.

Remaining economic life of office space:	35 years
Fair value of office space:	\$400,000

LE classifies the lease as an operating lease, because none of the tests for classification as a finance lease are met (see paragraph 6.2.50). There are no impairments (see section 6.5), no remeasurements (see section 6.6) or modifications (see section 6.7) during the lease term.

LE recognizes a single lease cost of \$17,154 each year of the 10-year lease, which is calculated as follows.



Whether a lease is classified as an operating or a finance lease, the carrying amount of the lease liability is the same throughout the lease term. Therefore, the carrying amount of the lease liability in this example is the same throughout the lease term as it is in Example 6.4.10, which at all times equals the present value of the unpaid lease payments (discounted at 10%, which is the discount rate for the lease determined at lease commencement in Example 6.3.10).

Following the subsequent measurement Method 1 (described and illustrated in Topic 842), LE subsequently accounts for the operating lease ROU asset as follows.

Year	Lease liability carrying amount	Unamortized IDCs <sup>1</sup>	Prepaid (accrued) lease payments <sup>2</sup>	ROU asset carrying amount
1	\$95,473	\$4,500	(\$2,127)	\$97,846
2	90,057	4,000	(3,818)	90,239
3	83,651	3,500	(5,060)	82,091
4	76,142	3,000	(5,840)	73,302
5	67,406	2,500	(6,144)	63,762
6	57,306	2,000	(5,956)	53,350
7	45,691	1,500	(5,263)	41,928
8	32,394	1,000	(4,050)	29,344
9	17,231	500	(2,301)	15,430
10	-	-	-	-

Notes:

1. Initial direct costs are amortized on a straight-line basis over the 10-year lease term.
2. Represents the cumulative difference between the annual straight-line lease cost (excluding initial direct costs) of \$16,654 and the amount of the lease payments.

### Scenario 2: Subsequent measurement using Method 2

As described in paragraph 6.4.170, the carrying amount of the ROU asset can be determined using a second method, which produces the same carrying amount as the method used in Scenario 1 throughout the lease term.



Note:

1. The amortization of the ROU asset each period is calculated as the difference between the straight-line lease cost for the period (including initial direct costs) and the periodic accretion of the lease liability using the effective interest method.

LE calculates the annual single lease cost for the 10-year lease term of \$17,154 in the same manner as illustrated above in Scenario 1.

However, the amortization of the ROU asset, and carrying amount of the ROU asset at the end of each period, are determined as follows.

Year	ROU asset amortization			ROU asset carrying amount		
	Straight-line lease cost	Lease liab. accret.	ROU asset amort.	Beg. balance	ROU asset amort.	End. balance
1	\$17,154	\$(10,000)	\$ 7,154	\$105,000	\$ (7,154)	\$97,846
2	17,154	(9,547)	7,607	97,846	(7,607)	90,239
3	17,154	(9,006)	8,148	90,239	(8,148)	82,091
4	17,154	(8,365)	8,789	82,091	(8,789)	73,302
5	17,154	(7,614)	9,540	73,302	(9,540)	63,762
6	17,153	(6,741)	10,412	63,762	(10,412)	53,350
7	17,153	(5,731)	11,422	53,350	(11,422)	41,928
8	17,153	(4,569)	12,584	41,928	(12,584)	29,344
9	17,153	(3,239)	13,914	29,344	(13,914)	15,430
10	17,153	(1,723)	15,430	15,430	(15,430)	-

### Method 1 vs. Method 2

As illustrated in this example, the ending balance of the ROU asset is the same throughout the lease term for the two scenarios. In addition, the single lease cost recognized by LE each period of the lease and the carrying amount of the

lease liability at the end of each period of the lease is unaffected by which subsequent measurement method LE chooses for the ROU asset.

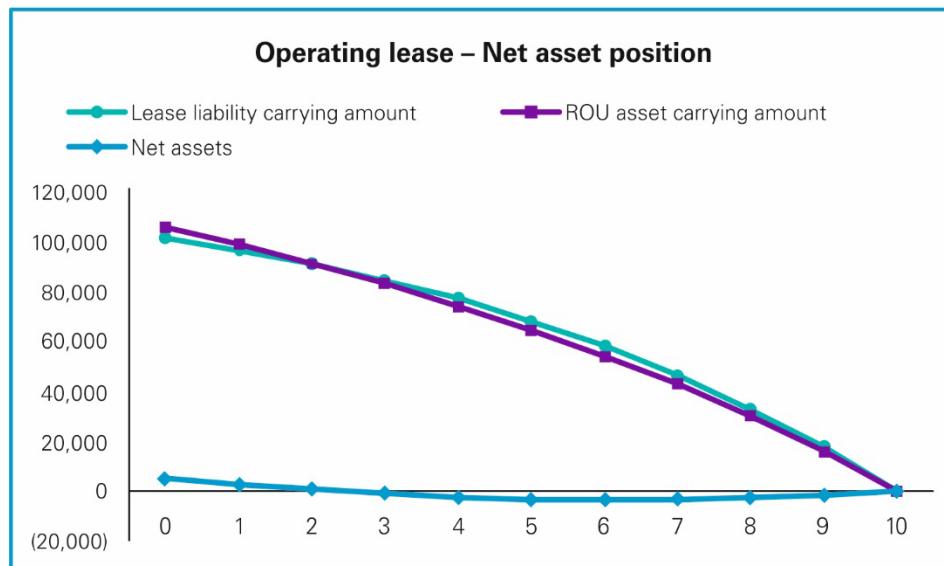


### Observation

#### **Operating lease ROU assets likely to track more closely to lease liability than finance lease ROU assets**

6.4.210 The carrying amount of an operating lease ROU asset is likely to track more closely to the carrying amount of the lease liability throughout the lease term than a finance lease ROU asset. As noted in paragraphs 6.4.100 – 6.4.110, a finance lease ROU asset will generally result in a negative net asset position for a particular lease. The balance sheet effect between an operating lease and a finance lease may be an important consideration relating to the effect on balance sheet ratios based on assets and liabilities.

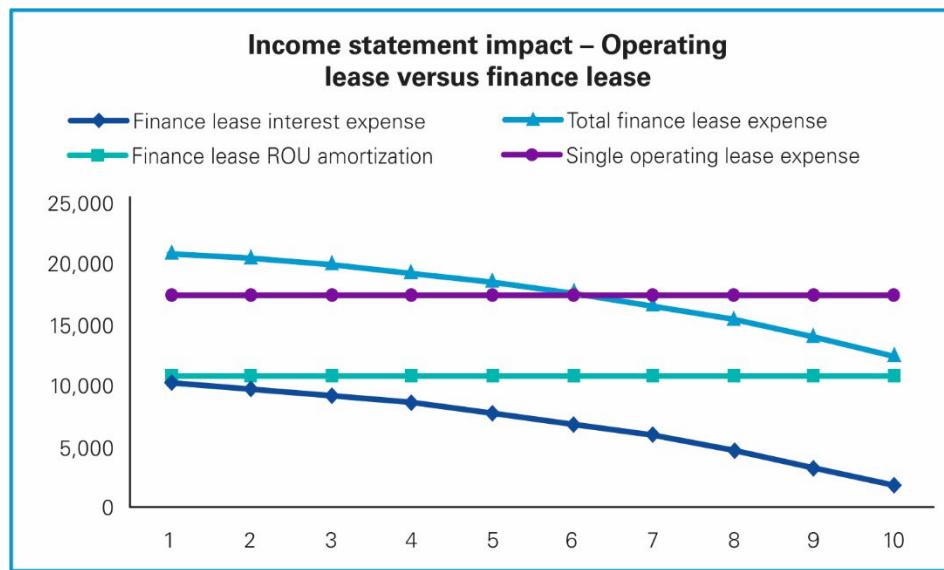
6.4.220 The following chart illustrates how the ROU asset tracks with the lease liability for Example 6.4.20.



### Observation

#### **Operating lease and finance lease expense recognition patterns differ**

6.4.230 The following chart depicts the differences in lease expense recognition patterns between a finance lease and an operating lease under Topic 842 using the fact pattern in Examples 6.4.10 and 6.4.20. The difference in expense recognition pattern may be less dramatic in a portfolio of leases; for example, for a lessee with a large revolving portfolio of leases that have varying maturities.



**Question 6.4.15**

**Single lease cost attribution – operating lease with non-consecutive period of use that is variable**

**How should a lessee recognize lease cost in an operating lease with a variable number of non-consecutive use periods?**

**Background:** Assume that a sports team (lessee) enters into a lease with a stadium owner (lessor) whereby the sports team has the right to use the stadium for 41 home games per year for 10 years, plus the right to use the stadium for any home playoff games during those 10 years (up to a maximum of 16 per year).

The sports team has exclusive rights to the stadium on each game day, and the stadium owner must ensure that the stadium is available for any regular season and playoff games – i.e. the stadium owner cannot book alternative events that it cannot cancel on any date when the sports team might need it. For simplicity, assume there are no renewal or termination options for either party in the contract.

As illustrated in Example 5.3.40, in an operating lease with a non-consecutive period of use, lease cost will be recognized only during the periods the lessee has the right to use the underlying asset. This is accomplished by, for those periods:

- ceasing amortization of the ROU asset; and
- capitalizing the accretion of the lease liability to the ROU asset.

However, for a lease like the background example, the question arises about how much lease cost to recognize during each right of use period, given that the total number of such periods is unknown.

**Interpretive response:** Topic 842 does not specifically address a situation where the period of use comprises a variable number of non-consecutive periods. Consequently, we believe there is likely more than one acceptable approach to this question.

Applied to the background example, we believe any one of the following three approaches is acceptable. Facts and circumstances may dictate whether all of these approaches, or other approaches, would be acceptable in scenarios that differ from that example.

**Approach 1: Assume the minimum number of use periods, and treat each addition thereto as a change in the lease term**

Under this approach, the lessee bases its lease cost recognition on the minimum number of periods it will have the right to use the asset (410 days in the background stadium example). The lessee does *not* estimate expected additional use periods (e.g. expected playoff games).

Each time the minimum number of periods the lessee will have the right to use the underlying asset increases, this reflects a change in the lease term. While the term is not necessarily being extended in these cases (i.e. the last non-consecutive use period may still be the same), it *is* being changed to reflect a different number of non-consecutive use periods. [842-10-35-1(c)]

In the background example, the sports team changes the lease term and its per-use day lease cost amount the first time it makes the playoffs, increasing the minimum total number of use days for the number of *guaranteed* home playoff games. It repeats this process each time the minimum increases throughout the contract period – e.g. if the first playoff series goes beyond the minimum number of home games, if the team makes the second playoff round and if the team makes the playoffs in later seasons.

Consistent with other changes to the lease term, the lessee recognizes the effect of the lease term change prospectively, remeasuring both:

- the per-use period lease cost it will recognize for periods after the lease term change (without adjusting lease cost previously recognized); and
- the lease liability (if it is not an unrecognized short-term lease – see section 6.3.1), following the guidance applicable to remeasuring a lease for other changes to the lease term (see section 6.6.2).

**Approach 2: Estimate the total number of periods of use at lease commencement, and revise periodically**

Under this approach, the lessee estimates the total number of periods it will have the right to use the asset using an appropriate systematic and rational approach. In the background example, the sports team estimates the total number of games it will play during the 10-year period, and therefore the number of days it will have the right to use the stadium during that period.

Lease cost is then recognized in equal amounts each period (e.g. each day in the background example) the lessee has the right to use the asset.

The lessee revises its estimate of the total number of periods it will have the right to use the asset periodically throughout the lease term when facts and circumstances indicate the lessee's current estimate is no longer reasonable.

Consistent with Approach 1, we believe a change to the lessee's estimate constitutes a change to the lease term and the lessee should account for such changes in the same manner.

### Approach 3: Treat each year of the contract as the lease cost unit of account

Under this approach, which we do not believe will be practicable or appropriate in all scenarios involving a period of use with a variable number of non-consecutive use periods, the lessee makes its estimates of usage for multiple shorter periods within the longer contract period, rather than for the entire contract period.

Applying this approach to the background example, the sports team considers that it has an enforceable right to use the asset for *up to* 570 days (i.e. the *maximum* number of home games the sports team could have over the 10-year contract term), with a maximum of 57 days per year. The stadium owner cannot book events for other teams or artists during the times when home playoff games are possible unless and until the team doesn't make, or gets eliminated from, the playoffs.

Based on this, the sports team recognizes an equal amount of lease cost each year of the 10-year contract term. Each year, the sports team recognizes lease cost as games are played based on an estimate of 'breakage' for the year. For example, if the team has a strong year and retains its talented players for the coming year, it might assume it will play 50 home games, and therefore recognize 1/50<sup>th</sup> of the annual lease cost as it plays each home game. If it becomes apparent it will play more or fewer games during the season, it will adjust its lease cost attribution *for the year* on a prospective basis.

This approach differs from Approach 2 principally in that it recognizes and attributes equal lease cost each year, and estimates games to be played only for the current year. In contrast, Approach 2 would only *coincidentally* result in equal lease cost recognition each year, and estimates games to be played for the entire contract period.



**Question 6.4.16**  
**Curtailment of the lessee's right to use the underlying asset**

### Should the lessee stop recognizing, or recognize reduced, operating lease cost (finance lease ROU asset amortization) when its rights to use the underlying asset have been curtailed?

**Background:** Situations arise in which the lessee's ability to use, and derive its intended economic benefits from using, the underlying asset are significantly curtailed. For example, as a result of COVID-19, retail store locations in shopping centers were closed to the public such that the retailer (lessee) could not sell its goods from the location, and restaurants were precluded from seating customers in their dining rooms (i.e. limiting their operations to carry-out

and/or delivery only). Similar circumstances may arise during periods of civil unrest or natural disasters.

The question arises as to whether it is appropriate to suspend or reduce operating lease cost (finance lease ROU asset amortization<sup>1</sup>) during the curtailment period.

Note:

1. For purposes of this question, references to finance lease ROU asset amortization should also be considered to apply to operating lease ROU asset amortization after it has been impaired (see paragraphs 6.5.40 – 6.5.50) or scheduled for abandonment (see Question 6.5.70).

**Interpretive response:** We believe it is inappropriate to suspend or reduce operating lease cost recognition (finance lease ROU asset amortization) as long as the lessee retains the right to use the underlying asset, even in a significantly curtailed manner.

The retailer in the background example cannot sell to customers from the location, but it has not vacated the space – e.g. its inventory is still stored there, and its leasehold improvements remain in place. Therefore, the retailer still retains control over the use of the space – i.e. control has not reverted to the landlord such that the landlord can use the space itself or re-lease it.

Topic 842 specifies that control over the use of an underlying asset is the equivalent of physical use; the recognition of operating lease cost (or finance lease ROU asset amortization) should not be affected by the extent to which the lessee uses the underlying asset. It would be inconsistent with that guidance for lease cost recognition (finance lease ROU asset amortization) to cease or be reduced as long as the lessee retains control over the use of the underlying asset. [842-20-55-3]

### 6.4.3 Impact of foreign currency

6.4.240 Regardless of lease classification as finance or operating, the ROU asset is a nonmonetary asset while the lease liability is a monetary liability. Therefore, for a lease denominated in a foreign currency, remeasurement into the lessee's functional currency is required using the following rates. [842-20-55-10, 830-10-45-17 – 45-18]

- **Lease liability.** The current exchange rate at the reporting date.
- **ROU asset.** The historical exchange rate used at the later of initial measurement (i.e. the commencement date) or the most recent remeasurement for which a reset of the exchange rate is required (see Question 6.4.25) or lease modification not accounted for as a separate contract.



### Question 6.4.20

#### **Accounting for the single lease cost for operating leases denominated in a foreign currency**

**What exchange rate(s) should be used to translate the single lease cost for an operating lease denominated in a foreign currency?**

**Interpretive response:** Although the operating lease cost is described in Topic 842 as a single lease cost, the operating lease cost actually consists of two components:

- the amortization of the ROU asset; and
- the expense associated with the accretion of the lease liability

In accordance with Topic 830 (foreign currency matters): [830-10-45-17 – 45-18, 830-10-55-10 – 55-11]

- the historical exchange rate determined in accordance with paragraph 6.4.240 should be used to remeasure the portion of the lease cost associated with the amortization of the nonmonetary ROU asset; and
- the average exchange rate for the period (appropriately weighted by the volume of transactions for the period and considering any major fluctuations in exchange rate during the period) should be used to remeasure the portion of the lease cost associated with the accretion of the monetary lease liability.

Consequently, the combined rate that will be used to translate the single lease cost for an operating lease is a blended rate.

If the entire single lease cost were remeasured using the average exchange rate for the period (consistent with how operating lease expense was generally remeasured under Topic 840) throughout the lease term, the ROU asset would not amortize to zero by the end of the lease term.



### Example 6.4.30

#### **Accounting for a lease denominated in a foreign currency**

Lessee LE enters into an operating lease for which the lease payments are denominated in Mexican pesos (MXN). LE's functional currency is US dollars (USD).

The following facts are relevant.

Lease term:	5 years
Lease payments in arrears:	Year 1: 100,000 MXN
	Years 2–5: Increasing by 5,000 MXN / year
Incremental borrowing rate:	6%

Initial direct costs and lease incentives:	None
Annual lease cost (sum of lease payments / 5 years):	110,000 MXN
Exchange rates:	Transaction date (historic): 1 USD / 20 MXN
(Average rate each year = rate at end of year)	End of Year 1: 1 USD / 24 MXN End of Year 2: 1 USD / 23 MXN End of Year 3: 1 USD / 22 MXN End of Year 4: 1 USD / 25 MXN End of Year 5: 1 USD / 26 MXN

The balances of the lease liability and ROU asset (and respective accretion and amortization, comprising the single lease cost) for each year in local MXN currency are as follows.

(in MXN)	Beginning	Year 1	Year 2	Year 3	Year 4	Year 5
<b>Lease liability ending balance<sup>1</sup></b>	<b>460,909</b>	<b>388,564</b>	<b>306,878</b>	<b>215,291</b>	<b>113,208</b>	-
Lease liability accretion <sup>2</sup>		27,655	23,314	18,413	12,917	6,792
ROU asset amortization <sup>3</sup>		82,345	86,686	91,587	97,083	103,208
<b>ROU asset ending balance</b>	<b>460,909</b>	<b>378,564</b>	<b>291,878</b>	<b>200,291</b>	<b>103,208</b>	-
Lease cost	110,000	110,000	110,000	110,000	110,000	110,000
Notes:						
1.	Present value of unpaid lease payments discounted at 6%.					
2.	Lease liability × 6%.					
3.	Annual straight-line lease cost (110,000 MXN) – lease liability accretion.					

The remeasured balances for each year in the functional currency of USD (using the average rate to remeasure the lease liability and the historical rate to remeasure the ROU asset) are as follows.

(in USD)	Beginning	Year 1	Year 2	Year 3	Year 4	Year 5
<b>Lease liability ending balance</b>	<b>23,045</b>	<b>16,190</b>	<b>13,343</b>	<b>9,786</b>	<b>4,528</b>	-
Transaction (gain) / loss		(3,840)	704	606	(1,175)	(174)
Lease liability accretion		1,152	1,014	837	517	261
Lease payment		(4,167)	(4,565)	(5,000)	(4,600)	(4,615)
<b>ROU asset ending balance</b>	<b>23,045</b>	<b>18,928</b>	<b>14,594</b>	<b>10,015</b>	<b>5,161</b>	-
ROU asset amortization		4,117	4,334	4,579	4,854	5,161

The single lease cost in USD for each year (the sum of the lease liability accretion and the ROU asset amortization in the chart above) is as follows.

	Year 1	Year 2	Year 3	Year 4	Year 5
Lease cost <sup>1</sup>	5,269	5,348	5,416	5,371	5,422
Note:					
1. Lease cost = Lease liability accretion + ROU asset amortization.					



### Question 6.4.25

#### Resetting the exchange rate used to remeasure the ROU asset into the lessee's functional currency

#### When should a lessee reset the historical exchange rate used to remeasure the ROU asset into the lessee's functional currency?

**Interpretive response:** This issue was recently the subject of consultation with the SEC staff. The staff expressed the view that either of the following approaches would be acceptable, treated as an accounting policy election applied to all of a lessee's leases.

##### Acceptable approaches

###### Approach 1 – Single exchange rate approach

Under this approach, a single exchange rate is used to remeasure a ROU asset into the lessee's functional currency, and a lessee resets the exchange rate when:

- there is a lease modification not accounted for as a separate contract (see section 6.7); or
- the lessee is required to remeasure the lease because of a change in (1) the lease term or (2) the assessment of a lessee option to purchase the underlying asset being exercised. (**Category A remeasurements**).

The exchange rate is reset in its entirety when there is a modification (not accounted for as a separate contract) on the basis that the Board views the modification as terminating the old lease and creating a new lease at the effective date of the modification. Therefore, the exchange rate used to remeasure the ROU asset should be consistent with the rate that would be used if the lease were an entirely new lease at that date. [IASU 2016-02.BC173]

Category A remeasurements also trigger the use of an updated exchange rate based on the following:

- In deciding that Category A remeasurements should result in an updated discount rate for the lease, the Board considered that, in those Category A scenarios, the economics of the lease have changed and those changes should be reflected in the discount rate. Effectively, the lessee takes a 'fresh look' at the lease. This 'fresh look' at the lease based on changed

economics includes updating the exchange rate used to remeasure the ROU asset.

- The Board, in concluding on the accounting for lease term extension modifications and lease term reassessments, concluded that Category A remeasurements and economically similar modifications should be accounted for consistently. Therefore, if a lessee should reset the exchange rate when there is a lease modification (not accounted for as a separate contract), it should also do so for Category A remeasurements.

In contrast to modifications (not accounted for as a separate contract) and Category A remeasurements, the exchange rate is not reset by the lessee if there is a remeasurement of the lease resulting only from either (1) a change in the amount probable of being owed under a residual value guarantee, or (2) resolution of a contingency that results in variable lease payments becoming fixed. (**Category B remeasurements**)

Differentiating between Category A and Category B remeasurements under Approach 1 is consistent with Topic 842's differentiation between these types of remeasurements in other areas. For example, in the event of Category A remeasurements, a lessee revises its discount rate for the lease and reassesses the lease classification, but does neither of those in the event of a Category B remeasurement. Those differences exist because, as noted above, Category A remeasurements were viewed by the Board as effectively taking a fresh look at the lease, based on changed economics, as of the remeasurement date. In contrast, Category B remeasurements were viewed differently. Category B remeasurements were considered to be solely updates to judgments or estimates affecting measurement of the lease, such that it was decided that neither the discount rate, nor lease classification, should be revised.

### ***Approach 2 – Layered approach***

Under this approach, the historical exchange rate determined at lease commencement is used to remeasure the original ROU asset, net of accumulated amortization, into the lessee's functional currency throughout the lease ('Layer 1'). Any increases to the ROU asset based on remeasurement of the lease liability, whether the result of a modification (not accounted for as a separate contract) or any type of reassessment event are remeasured into the lessee's functional currency using the exchange rate in effect at the effective date of the modification/reassessment date ('Layer 2'). Additional layers are then added for any further modifications or reassessments that result in an increase to the ROU asset. Therefore, multiple exchange rates may affect the remeasurement of the ROU asset into the lessee's functional currency.

As a practical matter, lessees following this approach may collapse multiple layers into a single, "blended" exchange rate used to remeasure the ROU asset into the functional currency. This blended exchange rate will differ from the reset exchange rate that would result from the application of Approach 1.

If a remeasurement is required that results in a reduction to the carrying amount of the ROU asset and there is only one layer, the historical exchange rate will not be updated. However, if there are multiple layers resulting from prior remeasurements, determining what exchange rate to apply to the remaining, reduced ROU asset may be more complex. In general, we believe

that if the layer to which the remeasurement applies can be specifically identified, the reduction to the ROU asset should be attributed specifically to that layer, and if a single, blended exchange rate is being used, it should reflect a reduction to that specific layer. For example, a layer may have been created in a prior remeasurement from a decision that a renewal option was reasonably certain to be exercised. If a subsequent reassessment reverses that decision, we believe the decrease to the ROU asset should be attributed specifically to that layer. In contrast, if the layer to which the remeasurement applies cannot be specifically identified (e.g. the remeasurement results from a modification that solely changes the consideration in the contract), we believe the decrease to the ROU asset should be attributed to each layer on a pro-rata basis using the layers' carrying amounts. In either case, if a single, blended exchange rate is being used, it will likely be different after the remeasurement.

Approach 2 is predicated on the general principles of Topic 830 (foreign currency matters), which indicate that a historical, and not current, exchange rate should be used to remeasure nonmonetary assets into the entity's functional currency. Consistent with the foreign currency accounting for other nonmonetary assets, only the new, additional piece (layer) of the ROU asset (e.g. added because of an increase in the lease term) should be remeasured into the functional currency using the exchange rate in effect at the date the layer is created. In addition, Approach 2 is based on the premise that Topic 842 was not intended to require lessees to recognize gains or losses from lease remeasurements, including for foreign exchange reasons, except when the remeasurement results in a reduction of the lease liability that is greater than the unamortized balance of the ROU asset. [830-10-45-17 – 45-18]

#### **Differences between the approaches**

The principal accounting difference between Approach 1 and Approach 2 is that Approach 1 will frequently trigger a foreign exchange gain or loss at the lease remeasurement date, while Approach 2 will not.

## 6.5 Impairment testing (Step 7)



### **Excerpt from ASC 842-20**

#### **25 Recognition**

##### **General**

**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 Subsequent Measurement

#### General

> Amortization of the Right-of-Use Asset for a Finance Lease

**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.

> Impairment of a Right-of-Use Asset

**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.

### 55 Implementation Guidance and Illustrations

#### General

> Illustrations

• > Illustration of Impairment of a Right-of-Use Asset

**55-47** Example 5 illustrates impairment of a right-of-use asset.

• • > Example 5—Impairment of a Right-of-Use Asset in an Operating Lease

**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.

**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 ( $\$100,000 \div 10 \text{ years}$ ).

**55-50** At the end of Year 3, when the carrying amount of the lease liability and the right-of-use asset are both \$53,893, Lessee determines that the right-of-use asset is impaired in accordance with Section 360-10-35 and recognizes an impairment loss of \$35,000. The right-of-use asset is part of an asset group that Lessee tested for recoverability because of a significant adverse change in the business climate that affects Lessee's ability to derive benefit from the assets within the asset group. The portion of the total impairment loss for the asset group allocated to the right-of-use asset in accordance with paragraph 360-10-35-28 is \$35,000. After the impairment charge, the carrying amount of the right-of-use asset at the end of Year 3 is \$18,893 ( $\$53,893 - \$35,000$ ). Because of the impairment, the total expense recognized in Year 3 is \$45,000 (\$10,000 in lease expense + the \$35,000 impairment charge). Beginning in Year 4, and for the remainder of the lease term, the single lease cost recognized by Lessee in accordance with paragraphs 842-20-25-6(a) and 842-20-25-7 will equal the sum of the following:

- a. Amortization of the right-of-use asset remaining after the impairment ( $\$18,893 \div 7 \text{ years} = \$2,699 \text{ per year}$ )
- b. Accretion of the lease liability. For example, in Year 4, the accretion is \$3,773 ( $\$53,893 \times 7\%$ ) and, in Year 5, the accretion is \$3,337 ( $\$47,665 \times 7\%$ ).

**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.

## 6.5.1 Applying the impairment testing requirements

6.5.10 A lessee uses the long-lived assets impairment guidance (Topic 360) to determine whether an ROU asset is impaired, and if so, the amount of the impairment loss to recognize. The impairment loss related to an ROU asset is presented in the same manner in the income statement as an impairment loss recognized for any other long-lived asset. [842-20-35-9]

6.5.20 Topic 842 characterizes operating lease liabilities as operating liabilities, rather than as debt. [ASU 2016-02.BC14(c)]



## Observation

### Long-lived assets impairment model for ROU asset impairment

6.5.30 The Board concluded that a lessee should not continue to recognize an ROU asset from which it does not expect to obtain future economic benefits or to measure that asset at an inflated amount above what the lessee expects to recover. The Topic 360 impairment model is the appropriate one to apply to ROU assets because the ROU asset in a finance lease or an operating lease is a long-lived, nonfinancial asset. [ASU 2016-02.BC255]



## Question 6.5.10

### Including lease liabilities in the carrying amount of the asset group in Step 1 of the impairment analysis

#### Should lease liabilities be included in the carrying amount of an asset group that includes ROU assets when performing Step 1 of the Topic 360 impairment test?

**Background:** The recoverability test for a held-and-used asset group (step 1 of the impairment test) excludes (1) financial and nonoperating liabilities from the carrying amount of the asset group, and (2) the cash flows attributable to the financial and nonoperating liabilities in determining the undiscounted future expected cash flows of the asset group – e.g. both interest and principal components of the financial and nonoperating liabilities should be excluded.

However, consistent with Example 1 to Topic 360, an entity should include operating liabilities (e.g. accrued liabilities and accounts payable) in the carrying amount and the cash flows used in the recoverability test. Any terminal value of the asset group included in the recoverability test should reflect the value inclusive of normal operating working capital assets and liabilities and not how the asset group is financed (e.g. through debt or equity). [360-10-55-20 – 55-22, ASU 2016-02.BC14]

**Interpretive response:** It depends. The conclusion as to whether a lease liability should be included in the carrying amount of the asset group to which the ROU asset relates depends on the classification of the lease as a finance lease or an operating lease.

#### Finance leases

For finance leases, no. The finance lease liability should be excluded in determining the carrying amount of the asset group, and the interest and principal components of the lease liability excluded in determining the undiscounted future expected cash flows of the asset group in the recoverability test.

This is consistent with the accounting related to capital leases under Topic 840; capital lease obligations were not included in the carrying amount of the asset group that includes the related capital lease assets. Capital lease obligations are

a financial liability that is equivalent to debt, and the impairment guidance in Topic 360 has long been premised on the view that debt, as simply a form of capitalization other than equity, should not be included in the asset group.

### **Operating leases**

For operating leases, we believe either of the following approaches would be consistent with US GAAP, although Approach A appears more consistent with how similar financial, but also operating, obligations (e.g. asset retirement obligations) are considered in the long-lived asset impairment guidance.

However, as demonstrated in Example 6.5.10, we believe entities should not come to different Step 1 impairment test conclusions regardless of the approach taken.

#### **Approach A**

Exclude the carrying amount of the lease liability in determining the carrying amount of the asset group, and therefore also exclude the operating lease payments in determining the undiscounted future expected cash flows of the asset group.

An operating lease liability is a financial liability even though the Board decided it should be characterized as an operating liability, rather than debt, for presentation purposes. We have observed that, in discussions about operating lease liabilities and their characterization as operating liabilities for presentation purposes, the Board frequently compared those lease liabilities to other discounted, financial liabilities that are also not characterized as debt, including those related to asset retirement obligations (AROs).

An analogy to AROs would suggest that Approach A is appropriate because, in accordance with Topic 360, the carrying amount of an ARO is excluded from the carrying amount of the asset group to which it relates, as are the estimated cash flows related to the liability. In addition, the introduction to ASU 2016-02 acknowledges leasing as a form of financing. Because the impairment guidance in Topic 360 is not intended to create different impairment results solely based on how an entity capitalizes (or finances its operations), this further supports our belief that Approach A is an acceptable application of the impairment guidance in Topic 360. [360-10-35-18]

#### **Approach B**

Include the carrying amount of the lease liability in determining the carrying amount of the asset group, and include the operating lease payments (net of the portion that relates to accretion of the operating lease liability) in determining the undiscounted future expected cash flows of the asset group.

The Board explicitly stated that operating lease liabilities are operating in nature. Therefore, consistent with the view that an entity should include operating liabilities (e.g. accrued liabilities and accounts payable) in the carrying amount of the asset group and in the undiscounted cash flows of the asset group, we believe Approach B is also an acceptable application of the impairment guidance in Topic 360.



### Question 6.5.20

#### **Short-term lease payments in the recoverability test**

**Are short-term lease payments included in determining the undiscounted future expected cash flows of the asset group to which the lease belongs if the short-term lease is not recognized on the balance sheet?**

**Interpretive response:** Yes. If a short-term lease is not recognized on the balance sheet (see paragraph 6.3.110), the short-term lease payments should be deducted from the undiscounted future expected cash flows of the asset group to which the lease relates.

If the short-term lease is recognized on the balance sheet, follow the guidance in Question 6.5.10.



### Question 6.5.30

#### **Variable lease payments in the recoverability test**

**Are variable lease payments included in determining the undiscounted future expected cash flows of the asset group to which the lease belongs?**

**Interpretive response:** Yes. A lessee should include expected variable lease payments in determining the undiscounted future expected cash flows of the asset group if such variable lease payments are not included in the measurement of the lease liability, for example because they are dependent on an index or rate (see section 5.4).



### Example 6.5.10

#### **Recoverability test for a held-and-used asset group that includes an ROU asset**

This example is a continuation of Examples 6.3.10 and 6.4.20, in which Lessee LE leases office space from Lessor LR for 10 years.

LE tests one of its asset groups for impairment because of a triggering event. The asset group being tested includes the ROU asset related to the office space that LE leases from LR. The impairment test coincides with the end of Year 2 of LE's lease.

The following additional facts are relevant.

Carrying amount of asset group:	\$770,000 (includes the ROU asset but not the operating lease liability)
Undiscounted future expected cash flows:	\$100,000 annually (before considering the lease payments associated with the lease)
Period over which recoverability test performed (for illustrative purposes):	8 years
Terminal value at the end of Year 8:	Nil

As outlined in Question 6.5.10, we believe it may be acceptable for an entity to apply either one of the following two approaches (A or B) as to inclusion of the operating lease liability in the asset group that includes the operating lease ROU asset.

#### **Scenario 1: Approach A – do not include operating lease liability in the asset group**

LE excludes the operating lease liability in determining the carrying amount of the asset group, and excludes the cash outflows from the lease payments in determining the undiscounted future expected cash flows of the asset group. Accordingly, LE's recoverability test is as follows.

	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8	Total
Undiscounted future expected cash flows before lease pmnts.	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000	\$800,000
<b>Effect of lease pmnts.</b>	-	-	-	-	-	-	-	-	-
<b>Total</b>	<b>\$100,000</b>	<b>\$800,000</b>							

Carry. amt. of asset group, excl. operating lease liab.	\$770,000	Asset group does not fail the recoverability test
Less carry. amt. of operating lease liab.	N/A	
Carry. amt. of asset group	770,000	
Total undiscounted future expected cash flows	800,000	
<b>Excess</b>	<b>\$ 30,000</b>	

#### **Scenario 2: Approach B – include operating lease liability in the asset group**

LE includes the lease liability in determining the carrying amount of the asset group, and includes the operating lease payments (net of the portion that relates to accretion of the operating lease liability) in determining the undiscounted future expected cash flows of the asset group. Accordingly, LE's recoverability test is as follows, the result of which is the same as under Approach A.

	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8	Total
Undiscounted future expected cash flows before lease pmnts.	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000	\$800,000
Effect of lease pmnts.	(15,412)	(15,874)	(16,350)	(16,841)	(17,346)	(17,866)	(18,402)	(18,954)	(137,045)
Add back portion related to lease liab. accret.	9,006	8,365	7,614	6,741	5,731	4,569	3,239	1,723	46,988
<b>Total</b>	<b>\$ 93,594</b>	<b>\$ 92,491</b>	<b>\$ 91,264</b>	<b>\$ 89,900</b>	<b>\$ 88,385</b>	<b>\$ 86,703</b>	<b>\$ 84,837</b>	<b>\$ 82,769</b>	<b>\$709,943</b>

Carrying amount of asset group, excluding operating lease liability	\$770,000
Less carrying amount of operating lease liability	(90,057)
Carrying amount of asset group	\$679,943
Total undiscounted future expected cash flows	709,943
<b>Excess</b>	<b>\$ 30,000</b>

Asset group does not fail the recoverability test

### Question 6.5.32

**Including operating lease liabilities in Step 1 of the impairment analysis results in negative carrying amount for the asset group**

**How is Step 1 of the Topic 360 impairment analysis affected if including operating lease liabilities in the asset group results in a negative carrying amount?**

**Background:** It is possible that the carrying amount of an asset group is negative – i.e. the carrying amount of the liabilities of the asset group exceed the carrying amount of the assets – because the lessee elects to apply Approach B in Question 6.5.10 when assessing its asset groups that include operating lease ROU assets for impairment under Topic 360.

A negative carrying amount for an asset group that results from using Approach B may occur for a variety of reasons and in different scenarios. However, we expect it to occur most frequently when:

- the operating lease ROU asset is the primary asset in the asset group – e.g. in many retail store scenarios or when the underlying asset is being subleased and that results in a change in the asset grouping for the head lease ROU asset; and
- the carrying amount of the lease liability exceeds the carrying amount of the ROU asset – e.g. when the lease payments escalate during the lease term or where the ROU asset has been partially impaired previously.

**Interpretive response:** We do not believe the evaluation of when the Step 1 recoverability test is required, or how the recoverability test is performed, differs when the carrying amount of the asset (asset group) is negative versus positive.

In either situation, if the undiscounted cash flows of the asset (asset group) are less than the carrying amount of the asset (asset group), including when the undiscounted cash flows are *more* negative than the carrying amount of the asset (asset group), the lessee proceeds to Step 2 of the impairment analysis. This means that if the carrying amount is negative (e.g. negative \$1,000), and the deficit of undiscounted cash outflows to undiscounted cash inflows is greater (e.g. the deficit is \$2,000), the entity must proceed to Step 2 of the impairment analysis (i.e. the fair value test).



### Example 6.5.15

#### Recoverability test for a held-and-used asset group that includes an ROU asset and has a negative carrying amount if including the operating lease liability

Assume the same office space lease described in Example 6.5.10, in which Lessee LE leases office space from Lessor LR for 10 years. However, assume that:

- the ROU asset is part of a different asset group – i.e. not the same asset group as in Example 6.5.10; and
- there is an impairment of the asset group containing the ROU asset at the end of Year 2 of the lease, of which \$20,000 was allocated to the ROU asset.

After the impairment, the ROU asset balance at the end of Year 2 is \$70,239: \$90,239 ROU asset balance at the end of Year 2 (see Example 6.4.20) less \$20,000 allocated impairment. Subsequently, LE amortizes the ROU asset on a straight-line basis over the remaining term of the lease (see paragraph 6.5.40). This results in annual amortization of \$8,780 (\$70,239 / 8 years remaining lease term).

At the end of Year 4 of the lease, LE concludes that significantly deteriorated economic conditions indicate that the already-impaired carrying amount of the asset group that includes the ROU asset may not be recoverable.

At the end of Year 4, the carrying amount of the ROU asset is \$52,679 (\$70,239 end of Year 2 carrying amount – \$17,560 amortization in Year 3 and Year 4). At the end of Year 4, the asset group comprises:

- the ROU asset and leasehold improvements (if following Approach A in Question 6.5.10); or
- the ROU asset, leasehold improvements and the lease liability (if following Approach B in Question 6.5.10).

	Approach A	Approach B
Carrying amount of the ROU asset	\$52,679	\$52,679
Carrying amount of leasehold improvements	\$8,000	\$8,000
Carrying amount of lease liability	N/A	\$(76,142)
Carrying amount of asset group	\$60,679	\$(15,463)
Undiscounted future expected cash flows (before lease payments associated with lease)	\$10,000 annually	\$10,000 annually
Period over which recoverability test performed	6 years	6 years
Terminal value at end of Year 10	Nil	Nil

### Scenario 1: LE follows Approach A – does not include operating lease liability in the asset group

LE excludes the operating lease liability from the carrying amount of the asset group, and therefore excludes the lease payments from the undiscounted future expected cash flows of the asset group. As a result, the following is LE's recoverability test, reflecting Years 5-10 of the lease.

	Yr 5	Yr 6	Yr 7	Yr 8	Yr 9	Yr 10	Total
Undiscounted future expected cash flows before lease pmts.	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000	\$60,000
Effect of lease pmts.	-	-	-	-	-	-	-
<b>Total</b>	<b>\$10,000</b>	<b>\$10,000</b>	<b>\$10,000</b>	<b>\$10,000</b>	<b>\$10,000</b>	<b>\$10,000</b>	<b>\$60,000</b>

Carrying amount of asset group	\$60,679	Asset group fails the recoverability test
Total undiscounted future expected cash flows	60,000	
<b>Deficiency</b>	<b>\$(679)</b>	

### Scenario 2: LE follows Approach B – includes operating lease liability in the asset group

LE includes the lease liability in the carrying amount of the asset group, and therefore includes the operating lease payments (net of the portion that relates to accretion of the operating lease liability) from the undiscounted future expected cash flows of the asset group. As a result, the following is LE's recoverability test, reflecting Years 5-10 of the lease; the result is the same as in Scenario 1.

	Yr 5	Yr 6	Yr 7	Yr 8	Yr 9	Yr 10	Total
Undiscounted future expected cash flows before lease pmts.	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000	\$60,000
Effect of lease pmts.	(16,350)	(16,841)	(17,346)	(17,866)	(18,402)	(18,954)	(105,759)
Add back portion related to lease liab. accr. acrt.	7,614	6,741	5,731	4,569	3,239	1,723	29,617
<b>Total</b>	<b>\$ 1,264</b>	<b>\$ (100)</b>	<b>\$ (1,615)</b>	<b>\$ (3,297)</b>	<b>\$ (5,163)</b>	<b>\$ (7,231)</b>	<b>\$(16,142)</b>

Carrying amount of asset group	\$15,463	
Total undiscounted future expected cash flows	(16,142)	
<b>Deficiency</b>	<b>\$16,142</b>	Asset group fails the recoverability test



### Question 6.5.33

#### Cash flows used in impairment testing

#### How is the Topic 360 impairment test affected if the impairment triggering event is not also a lease term or purchase option triggering event?

**Background:** Question 6.6.20 highlights that a Topic 360 impairment triggering event will not necessarily require *or permit* a reassessment of the lease term or a lessee purchase option. Question 6.6.20 uses the following example to illustrate.

Lessee LE leases a building, to be used as a retail store, from Lessor LR for a non-cancellable period of 10 years. The lease includes one 5-year renewal option. At lease commencement, LE concludes that it is reasonably certain to exercise the renewal option, and therefore the lease term is 15 years.

By Year 9, the retail location is performing poorly for reasons that were not anticipated at lease commencement, and LE decides that it will not exercise its renewal option. However, LE takes no action to vacate the retail location and decides that it will not communicate its decision to vacate to the lessor until it is required to do so, which is 60 days before the end of the 10-year non-cancellable period of the lease.

The poor performance of the retail location is an impairment triggering event under Topic 360, but is *not* a lease term reassessment event under Topic 842. [360-10-35-21, 842-10-35-1, 55-28]

Therefore, LE does not reassess whether the lease term is still 15 years (likely, it would not be) before assessing the ROU asset for impairment, and the question arises about the assumptions LE should use when performing the Topic 360 impairment test.

**Interpretive response:** Assuming the lease term or the assessment of a lessee purchase option would change if reassessed, both Step 1 and Step 2 of the Topic 360 impairment test are affected because the carrying amount of the ROU asset will generally be greater than if either of the following happened before undertaking the test: the lease term was reduced, or an assessment that a lessee purchase option is reasonably certain of exercise was reversed.

## Step 1 recoverability test

When performing the Step 1 recoverability test, the lessee's assumptions are based on its entity-specific plans, which are unaffected by whether it is able to reassess the lease term or a lessee purchase option first.

Using the background example, even though the ROU asset still reflects a 7-year remaining lease term, LE's Step 1 cash flows will be based on its plan not to renew the lease in 2 years – i.e. to return the remaining 5-year ROU asset to LR.

When LE estimates those Step 1 cash flows, there will be two components related to the ROU asset: [360-10-35-29 – 35-30]

- the cash flows from operating the asset for the next 2 years; plus
- the estimated terminal value of the ROU asset at the end of 2 years.

We believe the terminal value of the ROU asset should be its expected fair value (see Question 6.5.40 for ROU asset fair value considerations) as of the planned cease-use date. At that point, economically, the ROU asset represents LE's contractual *right* to renew the lease.

## Step 2 fair value test

In contrast to Step 1, Step 2 uses market participant assumptions, rather than entity-specific plans for use of the asset. Those market participant assumptions should be based on what a market participant would do if it was the lessee in a lease with a non-cancellable term equal to the unreassessed lease term. [360-10-35-17, 35-36]

Using the background example, LE will determine what a market participant would do if it had a 7-year non-cancellable remaining lease, rather than a 2-year remaining lease. A market participant in that situation might be unlikely to simply cease use of the retail location; rather, it might sublease the location to another user or continue to operate the location to generate cash flows.

## Go-forward accounting

If the lessee intends to terminate (or not renew) the lease before the end of the lease term, that will generally constitute a plan to abandon the ROU asset (see Question 6.5.50). Accordingly, the remaining carrying amount of the ROU asset (i.e. after any impairment taken) needs to be amortized to its salvage value by the planned lease end date (see Question 6.5.70).

Using the background example, LE will amortize the remaining carrying amount of the ROU asset at the beginning of Year 9 to its salvage value at the end of Year 10. The ROU asset's salvage value in this case will be the estimated fair value as of the planned cease-use date used in the Step 1 recoverability test.



### Question 6.5.35

#### **Including operating lease liabilities in the carrying amount of the asset group in Step 2 of the impairment analysis**

**Should operating lease liabilities be included in the carrying amount of an asset group that includes ROU assets when performing Step 2 of the Topic 360 impairment test?**

**Background:** Under Topic 360, if the undiscounted cash flows used to assess recoverability of the asset (asset group) are less than the carrying amount of the asset (asset group), the entity then proceeds to determine the fair value of the long-lived asset group and recognizes an impairment loss if the carrying amount exceeds that fair value. This is Step 2 of the Topic 360 impairment test. [360-10-35-17]

Question 6.5.10 outlines our view that it is acceptable to either include or exclude operating lease liabilities from the carrying amount of an asset group that includes associated operating lease ROU assets when performing the Step 1 recoverability test. This question addresses whether an entity should continue to follow its Step 1 approach when performing the Step 2 evaluation.

**Interpretive response:** In general, when performing the Step 2 impairment test, we would expect a lessee to follow the same approach that it applied when performing the Step 1 recoverability test (see Question 6.5.10).

- If the lessee **excludes** operating lease liabilities from the carrying amount of the asset group when performing the recoverability test (Approach A in Question 6.5.10), the lessee should exclude those same lease liabilities from the carrying amount of the asset group when performing Step 2 of the impairment test.
- If the lessee **includes** operating lease liabilities in the carrying amount of the asset group when performing the recoverability test (Approach B in Question 6.5.10), the lessee should include those same lease liabilities in the carrying amount of the asset group when performing Step 2 of the impairment test.

Irrespective of the approach taken, we would not expect a significant difference in the outcome of Step 2. This is because we would expect the lessee's estimate of the fair value of the asset group to appropriately reflect whether the asset group includes or excludes the operating lease liabilities. Question 6.5.36 discusses the effect on Step 2 of the impairment test of including or excluding operating lease liabilities from the carrying amount of the asset group.



### Question 6.5.36

#### **Effect of including or excluding operating lease liabilities in the carrying amount of the asset group in Step 2**

#### **How should inclusion or exclusion of operating lease liabilities in the carrying amount of an asset group affect the Step 2 impairment test?**

**Interpretive response:** The effects will differ depending on the approach taken to estimate the fair value of the asset group. We believe the most common approach will be a discounted cash flow approach, but other approaches, such as based on a market price for the asset group, may be used.

##### **Using a discounted cash flow approach**

###### ***Exclude vs. include the lease payments***

If the lessee excludes the operating lease liabilities from the carrying amount of the asset group (i.e. Approach A), it should also exclude the lease payments from the discounted cash flows used to measure the asset group's fair value.

This aligns the treatment of operating lease liabilities when assessing impairment under Topic 360 to asset retirement obligations (AROs), which the Board noted are similar in that they are discounted financial liabilities not characterized as 'debt'. Topic 360 is explicit that an asset group's fair value determined using discounted cash flows should exclude ARO payments; this is because ARO liabilities are excluded from the carrying amount of the asset group. This suggests an asset group's fair value determined using a discounted cash flow approach should exclude operating lease payments when the carrying amount of the asset group excludes the operating lease liabilities. [360-10-35-18 – 35-19]

In contrast, if the lessee includes the operating lease liabilities in the carrying amount of the asset group (i.e. Approach B), it would also include the lease payments in the discounted cash flows used to measure the asset group's fair value. Unlike the Step 1 recoverability test (see Question 6.5.10), the entire lease payments would be included, rather than solely the principal portion of the lease payments; this is because the cash flows used to estimate the asset group's fair value will be discounted.

###### ***Assumptions made in measuring fair value***

In using a discounted cash flow approach to measure fair value of the asset group, there are two key differences from the Step 1 recoverability test.

- The cash inflows and outflows that are used in measuring fair value are based on the assumptions that a market participant would make – they are not entity-specific. This is discussed in section D of KPMG Q&A, [Fair value measurement](#). [820-10-35-9]
- The cash flows are discounted, applying a rate that a market participant would require in assuming the risks associated with those cash flows – it is unrelated to the discount rate used by the lessee to account for the lease.

The discount rate used to discount the cash flows to present value depends on which approach the entity elects. [820-10-55-6]

- Under Approach A, the cash flows exclude the lease payments. To be consistent, the discount rate includes lease financing as an available source of capital.
- Under Approach B, the cash flows include the lease payments. To be consistent, the discount rate does not consider lease financing as an available source of capital. This is because, in concept, the lease payments included in the cash flows are already paying for the ROU asset(s).

In theory, the two approaches should result in the same fair value measurement. However, determining an appropriate discount rate, including adjustments required to observed market rates, may require the assistance of qualified valuation specialists.

### **Using a market price approach**

If the fair value of the asset group in Step 2 is estimated based on a quoted market price, it should reflect the lessee's decision about whether to include or exclude the operating lease liabilities from the carrying amount of the asset group. If it does not, an appropriate adjustment is made.

- The quoted market price should be increased if the lessee excludes the operating lease liabilities from the carrying amount of the asset group, but the quoted market price reflects the lessee's obligation to make the associated lease payments.
- The quoted market price should be decreased if the lessee includes the operating lease liabilities in the carrying amount of the asset group, but the quoted market price does *not* reflect the lessee's obligation to make the associated lease payments.



#### **Question 6.5.37**

**Including operating lease liabilities in Step 2 of the impairment analysis results in negative carrying amount for the asset group**

### **How is Step 2 of the Topic 360 impairment analysis affected if including operating lease liabilities in the asset group results in a negative carrying amount?**

**Background:** As discussed in Question 6.5.32, it is possible that the carrying amount of an asset group is negative – i.e. the carrying amount of the liabilities of the asset group exceeds the carrying amount of the assets – because the lessee elects to apply Approach B in Question 6.5.10 when assessing asset groups that include operating lease ROU assets for impairment under Topic 360.

Similar to Question 6.5.32, a question arises about the effect on the Step 2 Topic 360 impairment test of an asset (asset group) having a negative carrying

amount. In particular, can the fair value of the asset group be negative? If not, it would mean that no asset (asset group) with a negative carrying amount could be impaired, and therefore the exclusion (Approach A in Question 6.5.10) or inclusion (Approach B in Question 6.5.10) of operating lease liabilities in an asset group could affect whether an impairment exists.

**Interpretive response:** We believe the fair value of an asset (asset group) can be negative if an entity would effectively have to pay a market participant to take the asset group – i.e. because the acquirer would have to assume the liabilities that are part of the group. Accordingly, we do not believe a negative rather than a positive carrying amount of the relevant asset (asset group), should affect Step 2 of the impairment test under Topic 360.

Regardless of whether the carrying amount of the asset (asset group) is positive or negative, if the fair value of the asset (asset group) is less than its carrying amount – including when the fair value is *more* negative than the carrying amount – the lessee recognizes an impairment loss.

For example, if the carrying amount of an asset group is negative \$1,000 (because the entity followed Approach B in Question 6.5.10) and the fair value of the asset group is negative \$2,200, an impairment loss of \$1,200 is recognized, subject to the fair value limitation discussed in Question 6.5.40.



#### Question 6.5.40

#### Allocation of impairment losses to an asset group

### How should an impairment loss be allocated to an asset group that includes one or more ROU assets?

**Interpretive response:** An impairment of an asset group generally is allocated on a pro rata basis to all of the long-lived assets, including ROU assets, in the group on a relative carrying amount basis. This means that an ROU asset will often be written down because of an *allocated* impairment loss, rather than because of an event or change in circumstance specific to that ROU asset.  
[\[360-10-35-28\]](#)

When an asset group includes multiple operating lease ROU assets, all of those ROU assets will generally receive an allocation of the impairment loss.

Therefore, all of those leases will be subject to the post-impairment operating lease accounting model illustrated in Example 6.5.20.

Regardless of the approach (A or B) applied by the lessee in Questions 6.5.10 and 6.5.35, liabilities included in the asset group (if any) are not affected by the impairment of the asset group, nor are any assets in the group that are outside the scope of Topic 360.

Under Topic 360, the portion of an impairment loss allocated to an individual long-lived asset within an asset group (e.g. a specific ROU asset) cannot reduce the carrying amount of that asset below its fair value if that fair value is determinable without undue cost and effort (the ‘fair value limitation’). In that case, the amount of the impairment that can be allocated to the asset is restricted, with the excess loss being allocated to the other long-lived assets in

the group using the relative adjusted carrying amounts of those assets. Applying the fair value limitation may mean that the calculated deficit between the fair value and the carrying amount of the asset group is not fully recognized. See Example 6.5.17. [360-10-35-28, 55-22]

Determining the fair value of an ROU asset may involve judgment, and will be based on its highest and best use to a market participant. Effectively, the fair value of the ROU asset is the amount that a market participant would pay to have the use of that asset for the lease term without the obligation to make lease payments. Accordingly, an ROU asset will not have a fair value of zero, and therefore should not be fully impaired, if it would have utility to a market participant – e.g. if the underlying asset can be used or subleased by a market participant (regardless of the lessee's intent to do so). [820-10-35-10A – 35-14]

The measurement of fair value of an ROU asset for purposes of applying the fair value limitation should *exclude* the effect of the lessee's obligation to make lease payments even if the lessee is applying Approach B in Questions 6.5.10 and 6.5.35. This is because allocation of an impairment loss is based on the relative carrying amount of the long-lived assets in the asset group, without regard to any liabilities included in the carrying amount of the asset group.



### Example 6.5.17

#### Fair value test for a held-and-used asset group that includes an ROU asset and has a negative carrying amount if including the operating lease liability

This example continues Example 6.5.15, and illustrates Step 2 of the Topic 360 impairment test.

In Example 6.5.15, at the end of Year 4 of the lease, Lessee LE performed Step 1 of the impairment test, which indicated that the asset group was not recoverable.

LE now performs Step 2 of the impairment test to calculate any impairment loss. LE uses a discounted cash flow (i.e. income) approach to estimate the fair value of the asset group.

At the end of Year 4, the asset group comprises:

- the ROU asset and leasehold improvements (if following Approach A in Question 6.5.10); or
- the ROU asset, leasehold improvements and the lease liability (if following Approach B in Question 6.5.10).

	Approach A	Approach B
Carrying amount of ROU asset	\$52,679	\$52,679
Carrying amount of leasehold improvements	\$8,000	\$8,000
Carrying amount of lease liability	N/A	\$(76,142)
Carrying amount of asset group	\$60,679	\$(15,463)

	Approach A	Approach B
Undiscounted future expected cash flows (before lease payments associated with lease)	\$10,000 annually	\$10,000 annually
Period for which cash flows are considered	6 years	6 years
Terminal value at end of Year 10	Nil	Nil
Discount rate for future expected cash flows	8.5356% <sup>1</sup>	12%
Note:		
1.	The discount rate under Approach A is shown in greater precision so that the results of applying Approach A versus Approach B can be properly illustrated.	

### Scenario 1: LE follows Approach A – does not include operating lease liability in the asset group

Consistent with Scenario 1 in Example 6.5.15, LE excludes the operating lease liability from the carrying amount of the asset group. On that basis, LE also excludes the cash outflows from the operating lease payments in measuring fair value using a discounted cash flow approach.

Using the discount rate appropriate to those assumptions (see Question 6.5.35), LE's Step 2 fair value test is as follows.

	Yr 5	Yr 6	Yr 7	Yr 8	Yr 9	Yr 10	Total
Undiscounted future expected cash flows before lease pmts. <sup>1</sup>	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000	\$60,000
Effect of lease pmts.	-	-	-	-	-	-	-
Undiscounted cash flows	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000	\$60,000
<b>Discounted cash flows</b>	<b>\$ 9,214</b>	<b>\$ 8,489</b>	<b>\$ 7,821</b>	<b>\$ 7,206</b>	<b>\$ 6,640</b>	<b>\$ 6,117</b>	<b>\$45,487</b>
Note:							
1.	For simplicity, the LE-specific undiscounted future expected cash flows used in Example 6.5.15 are assumed to be the same future cash flows that would be expected by a market participant (see Question 6.5.35).						

Carrying amount of asset group	\$60,679
Total discounted future expected cash flows (fair value of asset group)	45,487
<b>Indicated impairment loss</b>	<b>\$(15,192)</b>

LE allocates the impairment loss pro rata to the long-lived assets in the asset group on a relative carrying amount basis. LE determines the stand-alone fair values of the ROU asset and the leasehold improvements to be \$40,000 and \$4,000, respectively.

Asset	Pre-impairment carrying amount (A)	Pro rata impairment allocation	Allocated impairment loss (B)	Post-impairment carrying amount (A – B)
ROU asset	\$52,679	\$13,189 <sup>1</sup>	\$12,679 <sup>2</sup>	\$40,000
Leasehold improvements	8,000	2,003 <sup>3</sup>	2,513 <sup>4</sup>	5,487
<b>Total</b>	<b>\$60,679</b>	<b>\$15,192</b>	<b>\$15,192</b>	<b>\$45,487</b>

Notes:

1.  $(\$52,679 / \$60,679) \times \$15,192$ .
2. The impairment of the ROU asset is limited to \$12,679 (see Question 6.5.40), which is the difference between the pre-impairment carrying amount (\$52,679) and its fair value (\$40,000). The difference (excess impairment) of \$510 ( $\$13,189 - \$12,679$ ) is reallocated to the leasehold improvements to the extent the reallocation does not result in impairing those assets below their fair value of \$4,000. [360-10-35-28]
3.  $(\$8,000 / \$60,679) \times \$15,192$ .
4. The entire \$510 excess impairment on the ROU asset is allocated to the leasehold improvements because this excess plus the allocated impairment (Note 3) does not impair those assets below their fair value of \$4,000.

### Scenario 2: LE follows Approach B – includes operating lease liability in the asset group

Consistent with Scenario 2 in Example 6.5.15, LE includes the operating lease liability in the carrying amount of the asset group. On that basis, LE also includes the entire operating lease payments – not just the principal portion – in measuring fair value using a discounted cash flows approach.

Using the discount rate appropriate to those assumptions (see Question 6.5.35), LE's Step 2 fair value test is as follows.

	Yr 5	Yr 6	Yr 7	Yr 8	Yr 9	Yr 10	Total
Undiscounted future expected cash flows before lease pmts. <sup>1</sup>	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000	\$60,000
Effect of lease pmts.	(16,350)	(16,841)	(17,346)	(17,866)	(18,402)	(18,954)	(105,759)
Undiscounted cash flows	(6,350)	(6,841)	(7,346)	(7,866)	(8,402)	(8,954)	(45,759)
<b>Discounted cash flows</b>	<b>\$ (5,670)</b>	<b>\$ (5,454)</b>	<b>\$ (5,229)</b>	<b>\$ (4,999)</b>	<b>\$ (4,768)</b>	<b>\$ (4,536)</b>	<b>\$ (30,655)</b>

Note:

1. For simplicity, the LE-specific undiscounted future expected cash flows used in Example 6.5.15 are assumed to be the same future cash flows that would be expected by a market participant (see Question 6.5.35).

Carrying amount of asset group	\$ (15,463)
Total discounted future expected cash flows (fair value of asset group)	(30,655)
<b>Indicated impairment loss</b>	<b>\$ (15,192)</b>

The impairment loss in Scenario 2 is the same as in Scenario 1 – and will be allocated to the ROU asset and leasehold improvements as in Scenario 1 –

highlighting how the assumptions used in each scenario are consistent with the decision of whether to apply Approach A or Approach B (see Question 6.5.36).

6.5.40 After the impairment of an ROU asset, the asset is measured at its carrying amount immediately after the impairment less any accumulated amortization subsequent to the impairment. Regardless of the lease classification, a lessee amortizes the ROU asset after impairment on a straight-line basis (unless another systematic basis is more representative of the pattern in which the lessee expects to consume the future economic benefits from the asset) from the date of impairment to the earlier of the end of the ROU asset's useful life or the end of the lease term. This accounting continues to apply if the ROU asset is remeasured due to a change in the lease liability post-impairment (see Question 6.6.120).



6.5.50 If an operating lease ROU asset has been impaired, for each period from the date of impairment through the end of the lease term, the single lease cost for the operating lease (which is still presented in a single income statement line item as before the impairment) is calculated as the sum of the following.  
[842-20-25-7]



Notes:

1. Determined for each remaining period during the lease term as the amount that produces a constant periodic discount rate on the remaining balance of the liability – i.e. the effective interest method.
2. See paragraph 6.5.40.



### Example 6.5.20

#### Operating lease accounting before and after impairment

Assume that instead of passing the recoverability test in Example 6.5.10, the asset group is impaired and the amount of the impairment allocated to the ROU asset is \$10,000. The following chart illustrates the accounting for the ROU asset before and after impairment.

Year	ROU asset carrying amount				Lease liability	Income statement <sup>2</sup>		
	Beg. Balance	ROU asset amort.	Impair. charge	End. balance		Carry. amt. (end. balance) <sup>1</sup>	Accret.	ROU asset amort.
1	\$105,000	\$ (7,154)	\$ -	\$97,846	\$95,473	\$10,000	\$ 7,154	\$ 17,154
2	97,846	(7,607)	(10,000)	80,239	90,057	9,547	7,607	17,154
3	80,239	(10,030)	-	70,209	83,651	9,006	10,030	19,036
4	70,209	(10,030)	-	60,179	76,142	8,365	10,030	18,395
5	60,179	(10,030)	-	50,149	67,406	7,614	10,030	17,644
6	50,149	(10,030)	-	40,119	57,306	6,741	10,030	16,771
7	40,119	(10,030)	-	30,089	45,691	5,731	10,030	15,761
8	30,089	(10,030)	-	20,059	32,394	4,569	10,030	14,599
9	20,059	(10,030)	-	10,029	17,231	3,239	10,030	13,269
10	10,029	(10,029)	-	-	-	1,723	10,029	11,752
Lease expense recognized during the lease term:								<b>\$161,535</b>
Impairment of ROU asset recognized in Year 2:								10,000
<b>Total lease cost:</b>								<b>\$171,535</b>
Notes:								
1. The lease liability carrying amount at the end of each year is unaffected by the impairment of the ROU asset – i.e. it is the same as in Example 6.4.20 where the ROU asset is not impaired.								
2. The accretion of the lease liability and the ROU asset amortization are shown separately for illustrative purposes only. For an operating lease, a lessee presents a single lease expense in the income statement, whether or not the ROU asset is impaired (and will not calculate these amounts separately before an impairment if the lessee applies Method 1 in subsequently measuring the ROU asset). However, the impairment loss allocated to the ROU asset will be presented in the same manner in the income statement as the remainder of the impairment loss allocated to other assets in the asset group.								

As illustrated in this example:

- The amortization of the ROU asset is determined as follows.
  - **Before impairment.** Amortization equals the difference between the straight-line lease cost for the period (\$17,154) and the periodic accretion of the lease liability using the effective interest method. LE uses Method 2 for the subsequent measurement of its operating lease ROU asset (see paragraph 6.4.170).
  - **After impairment.** Like a finance lease, it is amortized on a straight-line basis over the remaining lease term (ROU asset carrying amount post-impairment of \$80,239 / 8 remaining annual periods).
- The single lease cost is determined as follows.
  - **Before impairment.** So that the remaining cost of the lease is allocated over the remaining lease term on a straight-line basis (total lease cost at lease commencement of \$171,535 / 10 annual periods).

- **After impairment.** Front-loaded pattern of lease cost recognition due to the accretion of the lease liability, and amortization of the ROU asset, which is now on a straight-line basis over the remaining lease term (rather than as a balancing amount that increases each period throughout the lease term).



### Observation

#### Operating lease cost post-impairment similar to Topic 840

6.5.60 The front-loaded single lease cost recognition pattern post-impairment for an operating lease under Topic 842 has some similarities with the lease cost recognition that resulted for an operating lease under Topic 840 after the recognition of a termination cost liability under Topic 420 (exit or disposal cost obligations). [\[ASU 2016-02.BC257–BC259\]](#)

6.5.70 Under Topic 842, the post-impairment single lease cost for the remainder of the lease term will be front-loaded – i.e. the combination of the straight-line amortization of the remaining ROU asset and the accretion of the remaining lease liability. Similarly, under Topic 840, the remaining lease cost after recognition of a Topic 420 liability was front-loaded – i.e. the combination of the generally straight-line remaining lease expense, if any, and accretion of the contract termination liability. [\[ASU 2016-02.BC258\]](#)

6.5.80 In some cases, the net effect of those leases on the balance sheet under Topic 842 and Topic 840 will be similar. The generally net liability position of the lease under Topic 842 (i.e. carrying amount of the ROU asset less the carrying amount of the lease liability) may not differ substantially from the balance of the Topic 420 liability that would be recognized under current US GAAP.



### Comparison to legacy US GAAP

#### Impairment testing

6.5.90 Under Topic 840, consistent with the requirements in Topic 842 applicable to finance lease ROU assets, capital lease assets were assessed for impairment in accordance with the long-lived assets impairment guidance in Topic 360. However, finance lease assets may frequently have different carrying amounts than their capital lease asset counterparts. For example: [\[840-30-35\]](#)

- A finance lease ROU asset may have a lower carrying amount because it includes only amounts probable of being owed under a residual value guarantee rather than the full amount of the guarantee.
- A finance lease ROU asset may have a greater carrying amount because it may include amounts related to certain executory costs (e.g. payment of the lessor's costs for property taxes or insurance) that are excluded from a capital lease asset.

6.5.100 The differences in carrying amounts will affect the carrying amount of the asset group, and therefore could affect the results of the impairment analysis.

6.5.110 Topic 840 capital lease obligations were excluded from the carrying amount of the asset group (that includes the related capital lease assets) when performing the Topic 360 recoverability test. Finance lease liabilities are similarly excluded when determining the carrying amount of the asset group that includes those liabilities.

6.5.120 There were no operating lease ROU assets under Topic 840; therefore, assessing such assets for impairment is a new concept resulting from the issuance of Topic 842.

6.5.130 Charges were recognized for operating leases under Topic 840 based on the contract termination and other associated costs guidance in Topic 420, as well as sublease guidance that required a lessee to recognize a deficit between costs expected to be incurred under a sublease (e.g. lease payments and related executory costs) and anticipated sublease income. That guidance differs substantially from how operating lease ROU assets will be assessed for impairment under the long-lived assets impairment guidance. The sublease guidance applied only when a sublease had been entered into. Meanwhile, charges recognized in accordance with Topic 420 are generally only recognized at the earlier of: [420-10-25-12 – 25-13, 840-20-25-15]

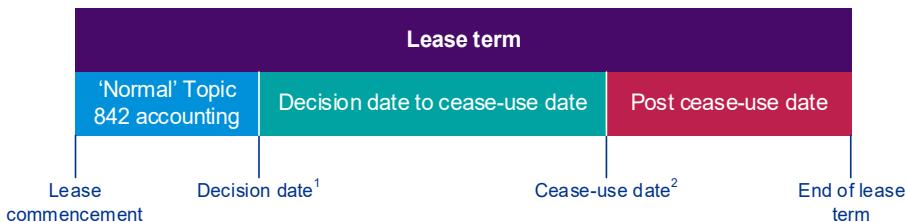
- when the lessee formally terminates the lease agreement (i.e. a contractual commitment is made through formal notice of intent to exercise a termination option or agreement is reached mutually with the lessor) the termination charge is measured at fair value; or
- when the lessee ceases use of the underlying asset (e.g. when the lessee vacates the building) the charge (and related liability) represents costs that will be incurred without economic benefit to the lessee, and is measured at fair value.

6.5.140 In addition to the differences above, another important difference is that a lessee recognizes charges in accordance with Topic 420 on a specific lease basis – i.e. a charge relates to a specific lease only. Under the long-lived assets impairment guidance, if an ROU asset is part of a larger asset group, it may receive an allocated impairment charge – i.e. an allocation of a larger impairment charge taken on all, or substantially all, of the assets in the asset group even if there is no specific indication that the ROU asset was impaired.

## 6.5.2 Interaction with Topic 360 when asset will be abandoned or subleased

6.5.150 The following series of questions and examples address a lessee ceasing use of an underlying asset (or portion thereof), either through abandonment or sublease. Although abandonment and subleasing differ in terms of the future economic benefits to be derived from the lease by the lessee (see Question 6.5.50), the accounting considerations are similar.

6.5.160 The following diagram is used throughout this section to differentiate the timing of the accounting considerations that are discussed – in particular, at the ‘decision date’, and in the period between the ‘decision date’ and the ‘cease-use date’. In sublease scenarios (see Question 6.5.90), the date that a sublease is entered into (i.e. ‘sublease inception’) is also a key date.



Notes:

1. The ‘decision date’ is the date on which the lessee commits to the plan to either abandon the ROU asset or sublease the underlying asset (or portion thereof).
2. The ‘cease-use date’ is the date on which the lessee stops using the underlying asset in its operations – e.g. the date the lessee vacates a leased facility that it is either abandoning or will sublease.

## Question 6.5.50 Abandonment and subleasing of an ROU asset

### Has a lessee abandoned an ROU asset if it has ceased use of the underlying asset but intends to sublease it?

**Interpretive response:** No. We believe an ROU asset has not been abandoned if the lessee has both the intent and the practical ability to sublease the underlying asset, even if a sublessee has not been identified by the cease-use date. This is because Topic 842 considers sublease payments to be economic benefits *from use* of the underlying asset. Consequently, a decision by the lessee to cease use of the underlying asset, and instead to sublease it, does not constitute an abandonment. [842-10-15-17]

In contrast, ceasing use of the underlying asset does constitute an abandonment of the ROU asset if the lessee either:

- does not intend to sublease the asset; or
- does not have the practical ability to sublease the asset.



### Question 6.5.55

#### Temporarily idling an underlying asset

#### Should temporarily idling an underlying asset change the lessee's lease cost recognition?

**Background:** Situations may arise in which a lessee chooses, or is forced, to idle an underlying asset. This can occur for a number of economic and/or business reasons, and the duration of the idling may initially be unknown. In fact, it may be uncertain whether the lessee will begin to use the underlying asset again during the lease term at all; however, the lessee has not committed to a plan to abandon the ROU asset (see Question 6.5.50).

In these situations, the question arises as to whether the pattern of operating lease cost recognition or finance lease ROU asset amortization should change.

Question 6.4.16 addresses lessee lease cost recognition when the lessee's ability to use, and derive economic benefits from using, the underlying asset is curtailed, but the lessee has not suspended its use of the underlying asset entirely.

**Interpretive response:** No. We believe it is inappropriate to suspend or reduce operating lease cost recognition (finance lease ROU asset amortization) as long as the lessee retains the right to use the underlying asset, even if it temporarily idles it. This is consistent with how entities account for temporarily idled property, plant and equipment – i.e. entities generally do not suspend or reduce depreciation when such assets are temporarily idled.

Topic 842 specifies that control over the use of an underlying asset is the equivalent of physical use; operating lease cost recognition (finance lease ROU asset amortization) should not be affected by the extent to which the lessee uses the underlying asset. It would be inconsistent with that guidance for lease cost recognition (finance lease ROU asset amortization) to be suspended or reduced as long as the lessee retains control over the use of the underlying asset, even if it has temporarily idled the asset. [842-20-55-3]

Temporarily idling an underlying asset is not 'abandoning' the ROU asset (see Question 6.5.50). Therefore, it is also inappropriate to *accelerate* operating lease cost recognition (finance lease ROU asset amortization) as outlined in Question 6.5.70 because the underlying asset is temporarily idled. [360-10-35-47 – 35-49]

When an underlying asset is temporarily idled, the lessee should consider whether that indicates the ROU asset may be impaired (see section 6.5.1).

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6.5.170 The following is a summary of the accounting issues that require consideration, highlighting at which key date accounting assessments are made and which Question addresses the issue.

6.5.180 The accounting steps are similar regardless of whether the whole or a portion of the underlying asset is being abandoned or subleased. However, the issues are more complex when only a portion of the underlying asset is affected and the lessee is accounting for its lease of the entire underlying asset as a single lease component – i.e. one ROU asset and one lease liability.

	Abandon		Sublease			
	Whole ROU asset	Portion of ROU asset	Whole underlying asset	Portion of underlying asset		
<b>At the decision date</b>						
<b>Reassess asset group?</b>	Question 6.5.60					
<b>Evaluate potential impairment</b>	Question 6.5.70	Question 6.5.80	Note 1	Question 6.5.90		
<b>Reevaluate unit of account</b>	N/A		N/A			
<b>Determine go-forward accounting</b>	Question 6.5.70		Note 1			
<b>At the earlier of cease-use date and sublease inception</b>						
<b>Reassess asset group?</b>	Question 6.5.60					
<b>Reevaluate unit of account</b>	N/A	Question 6.5.80	N/A	Question 6.5.90		
<b>Evaluate potential impairment</b>	N/A <sup>2</sup>	N/A <sup>2</sup>	Note 1			
<b>Determine go-forward accounting</b>	Question 6.5.70	Question 6.5.80	Note 1			

Notes:

1. This section does not include specific Questions or Examples related to the sublease of a whole underlying asset. The other sections of this chapter and chapter 8 address the accounting for the sublease of a whole underlying asset.
2. ROU asset carrying amount is \$0 by the cease-use date (see Question 6.5.70).



### Question 6.5.60

#### Changes in how a lessee uses an ROU asset and asset groups under Topic 360

**When does a lessee reassess its asset groups under Topic 360 if it plans to significantly change how it uses an ROU asset that is part of a larger asset group?**

**Background:** Under Topic 360, to recognize and measure an impairment loss, long-lived assets are grouped with other assets and liabilities at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities. [360-10-35-23]

As outlined in Question 3.3.110 of KPMG Handbook, [Impairment of nonfinancial assets](#), an entity should reassess its asset grouping if it experiences a change in facts and circumstances, including changes in:

- operating structure;
- the manner in which it deploys long-lived assets (other than routine changes in management); or
- the manner in which the entity expects to recover the asset.

For example, a lessee may decide to change how it uses an ROU asset by entering into a sublease rather than continuing to use the underlying asset in its ongoing operations.

A change in an asset group that results from changes in facts and circumstances is a change in estimate under Topic 250 (accounting changes and error corrections). An entity should comply with the disclosure requirements of Topic 250, including disclosing a change in asset grouping and the circumstances of the change. [\[250 Glossary, 250-10-50-4\]](#)

**Interpretive response:** The triggering event for reassessing asset groupings is generally the change in facts or circumstances, not the commitment to a plan to make the change. This means that committing to a plan to abandon an ROU asset or to sublease an underlying asset generally will not, in isolation, trigger a reassessment of asset grouping if the lessee is continuing to use the underlying asset in substantially the same manner as before committing to the plan. Until the lessee has undertaken substantive actions directly relevant to effecting that plan, the independence of cash flows likely has not changed for the original asset group; however, all facts and circumstances should be considered.

The following are examples of actions that would typically trigger a reassessment of an ROU asset's Topic 360 asset grouping (not exhaustive):

- the lessee enters into a sublease of the underlying asset;
- the lessee ceases use of the underlying asset; or
- the lessee significantly changes how the underlying asset is used in its operations – e.g. leased equipment is redeployed from one business unit to another, and the two business units' long-lived assets are not part of the same asset group.

If multiple changes in facts and circumstances occur, the lessee may need to undertake multiple asset grouping reassessments as those changes occur.



## Question 6.5.65

### Effect of temporary sublease on asset grouping

**Does entering into a sublease for only a portion of the remaining lease term trigger a change to the Topic 360 asset group for the affected ROU asset?**

**Background:** A lessee may enter into a sublease for only a portion of the remaining head lease term (a 'temporary sublease'). For example, the lessee may enter into a two-year sublease of office space subject to a head lease with a remaining lease term of 10 years.

In these circumstances, the question arises as to whether entering into a temporary sublease triggers a change to the asset grouping for the head lease ROU asset.

**Interpretive response:** It depends. Consistent with Question 6.5.60, entering into the temporary sublease is a change in circumstance that would typically trigger a reassessment of the asset group to which the head lease ROU asset belongs.

However, undertaking a reassessment does not automatically mean the asset group will change as a result. In the case of a temporary sublease, the lessee's plans for the ROU asset after the end of the sublease likely affect whether a change in asset group is appropriate.

For example, if the lessee intends to resume using the underlying asset in the manner it was used before entering into the sublease (e.g. reoccupy subleased office space for use by the same business unit at the end of the sublease) and the post-sublease period is not solely a minor portion of the remaining lease term at sublease inception, the temporary sublease would typically not trigger a change to the asset group for the head lease ROU asset. In that case, the independence of the identifiable cash flows related to the ROU asset likely has not changed.

By contrast, if the lessee intends to continue subleasing the underlying asset after the end of the temporary sublease for a total sublease period that comprises at least most of the remaining head lease term, it is likely the identifiable cash flows related to the ROU asset are now largely independent of the cash flows of the other assets and liabilities with which it had been grouped previously.

The lessee's specific facts and circumstances need to be considered when determining whether a change in asset group is appropriate, and it is possible that an initial conclusion reached when a temporary sublease is entered into will need to be revisited if facts and circumstances change.



### Question 6.5.66

#### Bifurcating a single ROU asset for a temporary sublease

### Is it acceptable to bifurcate a single ROU asset into one for the period of a temporary sublease and another for the remainder of the head lease term?

**Background:** Assume the same example as in the background to Question 6.5.65. In that scenario, the question has also arisen as to whether it is acceptable for the head lessee/sublessor to bifurcate the original, single ROU asset for the office space into two ROU assets, one for the two-year temporary sublease term and another for the eight-year remaining lease term post-sublease.

If an entity is able to bifurcate the 10-year ROU asset, the two-year ROU asset linked to the temporary sublease might qualify as its own asset group (see Question 6.5.60), which may be impaired if the sublease is loss-making.

**Interpretive response:** No. It is not acceptable to bifurcate a single ROU asset into two or more separate ROU assets based on time periods within the head lease term. To do so would be inconsistent with the Topic 842 concept outlined most clearly in the lease modification guidance that an extension of the right to use an underlying asset is *not* an 'additional right of use'. Instead, the period of time over which the lessee has the right to control the use of the underlying asset is an *attribute* of that singular right of use. [842-10-55-164, ASU 2016-02.BC176(b)]



## Question 6.5.70

### Accounting for the abandonment of an ROU asset

#### How should a lessee account for the abandonment of an ROU asset that is part of a larger asset group?

**Interpretive response:** We believe the lessee should undertake the following steps to account for the abandonment of an ROU asset (see Question 6.5.50) that is part of a larger Topic 360 asset group.

##### 1. Evaluate whether the asset group is impaired

The lessee continues to evaluate impairment under Topic 360 at the same asset group level after committing to the plan to abandon the ROU asset as before committing to the plan (see Question 6.5.60).

However, committing to the plan of abandonment may constitute a triggering event, requiring an assessment of possible impairment for the larger asset group at the decision date. That assessment, as well as the recognition of any impairment loss, follows the guidance in Topic 360. An impairment indicator associated with a single ROU asset within a larger asset group may not signify a need to test the entire asset group for impairment. A lessee should consider the significance of the to-be-abandoned ROU asset to the asset group as a whole before concluding the asset group needs to be tested for impairment. [360-10-35-21]

If the asset group is not impaired, there is no basis in Topic 360 or Topic 842 to immediately write down the carrying amount of the ROU asset that will be abandoned.

##### 2. Determine go-forward accounting

It is necessary to consider the go-forward accounting at the decision date if the ROU asset is either not impaired or is only partially impaired in Step 1.

The lessee should update its estimate of the useful life of the ROU asset (i.e. shorten it) to ensure that the to-be-abandoned ROU asset is amortized to its salvage value over the period of its remaining expected use. The salvage value of an ROU asset is likely to be zero (except potentially in scenarios consistent

with that in Question 6.5.33), and the useful life will end at the expected cease-use date. [360-10-35-47, ASU 2016-02.BC255]

We believe there are two acceptable approaches to amortize the ROU asset over the remainder of its shortened useful life if no impairment of the ROU asset has been recognized – i.e. either as a result of Step 1 in this response or at any time before the decision date. In contrast, if the ROU asset is partially impaired (even if only by an insignificant amount), only Approach 1 is acceptable (see paragraphs 6.5.40 – 6.5.50). Under both approaches:

- the ROU asset is amortized to its salvage value (frequently, \$0) by the cease-use date;
- the amount of ROU amortization between the decision date and the cease-use date is greater than the amortization that would have been recognized if there were no plan to abandon the ROU asset; and
- there is no change in how the lessee accounts for the lease liability throughout the remainder of the lease term – i.e. accretion of the lease liability remains the same as if there were no plan to abandon the ROU asset, and the lease liability balance will be the same amount it would have been had there been no abandonment.

#### ***Approach 1: Loss of straight-line lease cost***

The lessee amortizes the ROU asset over the revised remaining useful life (i.e. from the decision date to the cease-use date) on a straight-line basis.

Because the lease liability continues to be accreted in the same manner as before the decision date, the single lease cost is front-loaded over the remaining lease term similar to what occurs after impairment of an operating lease ROU asset (see Example 6.5.20).

#### ***Approach 2: Adjusted straight-line lease cost***

Rather than amortizing the ROU asset on a straight-line basis from the decision date to the cease-use date, the lessee amortizes the ROU asset to result in both:

- a ROU asset carrying amount at the cease-use date equal to its salvage value; and
- a straight-line total lease cost from the decision date to the cease-use date when combined with the accretion of the lease liability.

If the ROU asset becomes impaired at any point between the decision date and the cease-use date (e.g. because there is an intervening impairment of the asset group), the lessee is required to revert to Approach 1 from the impairment date (see paragraphs 6.5.40 – 6.5.50 and Example 6.5.20).

#### ***Accounting after the cease-use date***

There is no specific new accounting after the cease-use date. The single lease cost between the cease-use date and the end of the lease term may be comprised solely of the lease liability accretion if the ROU asset is fully amortized by the cease-use date (i.e. because its salvage value determined to be \$0 at that date).



## Example 6.5.30

**Abandonment of an ROU asset that is part of a larger asset group**

Lessee LE enters into a contract with Lessor LR for the right to use a machine for seven years with no renewal options. The right to use the machine is a lease and there are no other components of the contract.

The following facts are relevant at the lease commencement date.

Lease payments:	Fixed payments of \$1,000 per year in arrears
LE's incremental borrowing rate:	6% (the rate implicit in the lease cannot be readily determined)
Lease liability recognized: <sup>1</sup>	\$5,582
ROU asset recognized: <sup>2</sup>	\$5,582
Notes:	
1. Calculated as the present value of the seven lease payments of \$1,000, discounted at the incremental borrowing rate of 6%. 2. Calculated as the initial measurement of the lease liability because there are no initial direct costs, prepaid lease payments or lease incentives received.	

LE appropriately classified the lease as an operating lease, because none of the tests for classification as a finance lease were met (see paragraph 6.2.50).

The ROU asset for the leased machine is part of an asset group comprising other ROU assets and owned assets.

At the beginning of Year 2 (the decision date), when the carrying amounts of the lease liability and the ROU asset are both \$4,917, LE decides that it will cease using the machine after Year 5 – i.e. two years before the end of the lease term. Between the decision date and the end of Year 5, LE plans to continue using the leased machine in the same manner, and as part of the same operation, as before the decision date.



LE does not intend to sublease the asset. Consequently, LE intends to abandon the ROU asset before the end of the lease term (see Question 6.5.50).

**1. Evaluate whether the asset group is impaired when LE commits to the plan to abandon the ROU asset**

Consistent with the response to Question 6.5.60, LE's decision to cease use of the ROU asset does not trigger a reassessment of the asset group that

contains the ROU asset; therefore, the ROU asset remains part of the larger asset group subsequent to the decision date.

LE concludes there is no impairment of the asset group that contains the ROU asset based on an appropriate analysis under Topic 360.

## 2. Determine go-forward accounting

Because LE plans to abandon the ROU asset at the end of Year 5, LE updates its estimate of the remaining useful life of the ROU asset to ensure it is amortized to its estimated salvage value of \$0 by the end of that revised useful life.

### **Approach 1: Loss of straight-line lease cost**

LE recalculates the annual amortization of the ROU asset over its remaining expected useful life of four years from the decision date. The total single lease cost each period of the remaining lease term equals the sum of the amortization of the ROU asset and the accretion of the operating lease liability.

Amortization of the ROU asset over the remaining expected useful life of four years from the decision date occurs on a straight-line basis, while the lease liability continues to be accreted over the remainder of the 7-year lease term in the same manner as before the decision date.

Year	ROU asset amortization			ROU asset carrying amount		
	Single lease cost	Lease liab. accret. <sup>2</sup>	ROU asset amort.	Beg. balance	ROU asset amort.	End. balance
1	\$1,000	\$335	\$ 665	\$5,582	\$ (665)	\$4,917
2	1,524 <sup>1</sup>	295	1,229 <sup>3</sup>	4,917	(1,229)	3,688
3	1,482	253	1,229	3,688	(1,229)	2,459
4	1,437	208	1,229	2,459	(1,229)	1,230
5	1,390	160	1,230	1,230	(1,230)	-
6	110	110	-	-	-	-
7	57	57	-	-	-	-

Notes:

1. The single lease cost for an operating lease is generally calculated so that the remaining cost of the lease is allocated over the remaining lease term on a straight-line basis. As of the decision date, amortization of the ROU asset is no longer calculated to result in a straight-line total lease cost (see Example 6.5.20).
2. Calculated as beginning balance of lease liability multiplied by incremental borrowing rate: Year 1 =  $\$5,582 \times 6\%$ , Year 2 =  $\$4,917 \times 6\%$ , etc.
3. Calculated as balance of ROU asset at beginning of Year 2 divided by remaining expected useful life:  $\$4,917 / 4$  years.

### **Approach 2: Adjusted straight-line lease cost**

LE amortizes the ROU asset to result in both (1) a \$0 ROU asset carrying amount at the cease-use date at the end of Year 5, and (2) a straight-line total lease cost for the four years between the decision date and the cease-use date (when combined with the accretion of the lease liability).

Year	ROU asset amortization			ROU asset carrying amount		
	Single lease cost	Lease liab. accret.	ROU asset amort.	Beg. balance	ROU asset amort.	End. balance
1	\$1,000	\$335	\$ 665	\$5,582	\$ (665)	\$4,917
2	1,458 <sup>1</sup>	295	1,163	4,917	(1,163)	3,754
3	1,458	253	1,205	3,754	(1,205)	2,549
4	1,458	208	1,250	2,549	(1,250)	1,299
5	1,459	160	1,299	1,299	(1,299)	-
6	110	110	-	-	-	-
7	57	57	-	-	-	-

Note:

- Calculated as lease cost for Years 2–5 divided by remaining estimated useful life:  
 $(\$4,917 + \$295 + \$253 + \$208 + \$160) / 4 \text{ years.}$



### Question 6.5.80

#### Accounting for the abandonment of a portion of a single ROU asset

### How should a lessee account for the abandonment of a portion of a single ROU asset?

**Background:** For purposes of this question, a lessee has leased an entire office building with five floors and accounted for that lease as a single separate lease component – i.e. as a single unit of account. Partway through the lease term, the lessee commits to a plan to abandon one of the five floors (see Question 6.5.50). In other words, the lessee will abandon a portion of its ROU asset.

**Interpretive response:** We believe the lessee should undertake the following steps to account for the abandonment of a portion of an ROU asset.

#### 1. Evaluate whether the asset group is impaired

Evaluating whether the asset group is impaired is not substantively different from the process described in Step 1 in Question 6.5.70. The only difference is that it is a portion of an ROU asset that will be abandoned – not an entire ROU asset.

#### 2. Reevaluate the unit of account

A decision about whether the right to use the portion of the underlying asset that will be abandoned should be separated from the larger, existing ROU asset covering the lessee's right to use the entire underlying asset is important because it determines the go-forward accounting described in Step 3.

At the decision date, we believe the lessee should evaluate why the existing, single separate lease component is a single unit of account. The lessee should determine whether this is the case:

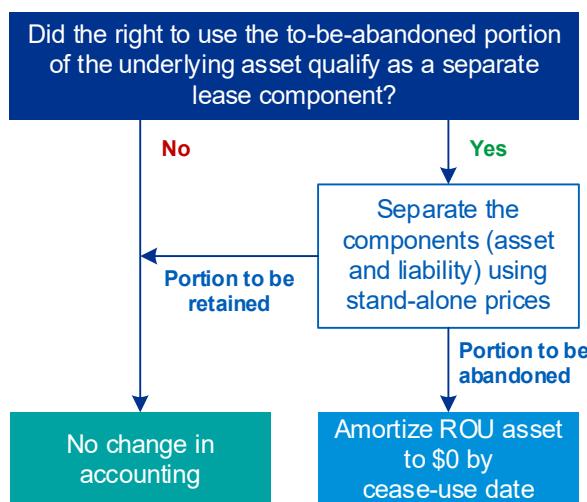
- because there was only a single separate lease component when it was assessed in accordance with paragraph 842-10-15-28 (see section 4.1); or instead
- because the lessee in effect applied a portfolio approach (see section 5.8) – i.e. accounted for multiple separate lease components as a single separate lease component.

As a practical matter, the lessee may not have previously evaluated this question. For example, the lessee may not have assessed, in deciding to account for the lease of the multi-floor building as a single unit of account, whether the building was a single separate lease component or multiple separate lease components. The assessment may have had no perceived accounting effect at that time. However, upon committing to a plan to abandon a portion of the ROU asset, we believe the lessee needs to evaluate this question to properly account for the planned abandonment going forward.

This assessment undertaken at the decision date is based on the facts and circumstances that existed when this evaluation would have taken place previously, and does not take into account subsequent changes in circumstances – e.g. the changed market desirability of a particular floor of an office building.

### 3. Determine go-forward accounting

The reevaluation of the unit of account when only a portion of the ROU asset will be abandoned makes the analysis of the go-forward accounting more complex. The following diagram summarizes the additional step in the process, which is explained in detail in the discussion that follows.



#### ***No separation required (single separate lease component previously)***

If, upon evaluation in Step 2, there was only a single separate lease component, the to-be-abandoned portion of the ROU asset remains part of a single ROU asset – i.e. the unit of account for the lessee's lease accounting is not revised.

Therefore, neither the ROU asset, nor any portion of the ROU asset, is subject to the accelerated amortization model described in Question 6.5.70; this is because the single ROU asset is not being abandoned.

The lessee's accounting for the lease liability associated with the single ROU asset is also unaffected by the lessee's decision to abandon a portion of the ROU asset.

***Separation required (right to use the to-be-abandoned portion of the underlying asset was a separate lease component previously)***

If the right to use the to-be-abandoned asset met the criteria to be a separate lease component, a portion of the existing ROU asset reflecting that separate lease component should be separated from the existing ROU asset and the accelerated amortization model in Question 6.5.70 should be applied to it.

A portion of the existing lease liability should also be allocated to the newly separate lease component. The lessee's accounting for the newly separate lease liability is unaffected by the fact that the related ROU asset will be abandoned – i.e. the lessee accounts for the lease liability in the same manner as if the ROU asset were not going to be abandoned.

We believe the lessee should allocate the carrying amount of the existing ROU asset and lease liability to (1) the new, separate lease component (i.e. the right to use the portion of the underlying asset that will be abandoned), and (2) the separate lease component that reflects the remainder of the original lease, on a relative stand-alone price basis.

Because Topic 842 does not address allocation in this situation, we believe a lessee could base the relative stand-alone price allocation on either:

- the stand-alone prices the lessee would have determined for the two separate lease components had they previously been accounted for separately (historical stand-alone prices); or
- the stand-alone prices of the two separate lease components at the date the lessee commits to the plan of abandonment (decision date) based on the remaining lease term and the then-current facts and circumstances – e.g. current observable stand-alone prices (current stand-alone prices).

The lessee's accounting for the separate lease component that reflects the remainder of the original lease is accounted for from the separation date in the same manner as any other separate lease component.



#### Example 6.5.40

##### Abandonment of a portion of a leased building

Lessee LE enters into a contract with Lessor LR for the right to use a five-story office building for five years with no renewal options. The right to use the building is a lease and there are no other components of the contract. There have been no modifications to (or remeasurements of) the lease.

The following facts are relevant at the lease commencement date.

Lease payments (gross lease):	Fixed payments of \$1,000 per year in arrears
LE's incremental borrowing rate:	6% (the rate implicit in the lease cannot be readily determined)
Lease liability recognized: <sup>1</sup>	\$4,212
ROU asset recognized: <sup>2</sup>	\$4,212
Notes:	
1. Calculated as the present value of the five lease payments of \$1,000, discounted at the incremental borrowing rate of 6%.	
2. Calculated as the initial measurement of the lease liability because there are no initial direct costs, prepaid lease payments or lease incentives received.	

LE appropriately classified the lease as an operating lease, because none of the tests for classification as a finance lease were met (see paragraph 6.2.50). LE did not separately account for the implied land element of the lease (see Question 4.1.20) because the accounting effect of doing so would have been insignificant – i.e. the coterminous land and building elements separately would have both been classified as operating leases.

At the beginning of Year 2 (the decision date), when the carrying amount of the lease liability and the ROU asset are both \$3,465, LE decides that it will cease use of the top floor of the building at the end of Year 3 – i.e. two years before the end of the lease term. Between the decision date and the end of Year 3, LE plans to continue using the top floor of the building in the same manner, and as part of the same operation, as before the decision date.



LE would have the practical ability to sublease the top floor after it ceases use of it, but does not intend to do so. Consequently, LE plans to abandon the ROU asset before the end of the lease term (see Question 6.5.50).

### 1. Evaluate whether the asset group is impaired

Consistent with the response to Question 6.5.60, LE's decision to cease use of part of the building does not trigger a reassessment of the asset group that contains the entire building ROU asset; therefore, the ROU asset remains part of the larger asset group subsequent to the decision date.

LE concludes that there is no impairment of the asset group that contains the entire building ROU asset based on an appropriate analysis under Topic 360.

## 2. Reevaluate the unit of account

While LE has accounted for the building lease as a single unit of account (one ROU asset and one lease liability) to date, upon deciding to abandon the top floor of the building, LE concludes that the top floor of the building previously met the criteria to be accounted for as a separate lease component:

- LE could benefit from the top floor on its own – i.e. separate from the other four floors of the building. This is evident because:
  - LE can practically sublease the top floor to a third-party sublessee; and
  - LR and other lessors regularly lease different floors in similar office buildings to unrelated lessees.
- The right to use the top floor is not highly dependent on, nor highly interrelated with, LE's right to use the remainder of the building. At contract inception, the building was already divided into multiple floors such that LR could have granted separate rights to multiple lessees to use different floors of the building or transferred rights to LE to use the different floors with different commencement dates.

## 3. Determine go-forward accounting

### ***Separate and allocate the existing ROU asset and lease liability to the two separate lease components created by Step 2***

Based on the conclusion reached in Step 2, LE separates its lease of the top floor from its lease of the remainder of the office building. LE allocates between the top floor lease component and the lease component for the remainder of the building on a relative stand-alone price basis as follows. In this example, LE elects to use historical stand-alone prices (see Question 6.5.80).

Separate lease component	Stand-alone price	Allocated ROU asset	Allocated lease liability
Top floor	\$1,165	\$ 807 <sup>2</sup>	\$ 807 <sup>2</sup>
Remaining floors	3,835	2,658 <sup>3</sup>	2,658 <sup>3</sup>
<b>Total</b>	<b>\$5,000<sup>1</sup></b>	<b>\$3,465</b>	<b>\$3,465</b>

Notes:

1. Because LE is using historical rather than current stand-alone prices, those prices are based on two five-year leases.
2.  $\$807 = (\$1,165 / \$5,000) \times \$3,465$  (carrying amount at beginning of Year 2).
3.  $\$2,658 = (\$3,835 / \$5,000) \times \$3,465$  (carrying amount at beginning of Year 2).

### ***Update useful life for new top floor ROU asset and account for new top floor separate lease component***

Because LE plans to abandon the top floor ROU asset after Year 3, LE updates its estimate of the remaining useful life of the ROU asset to ensure it is fully amortized by the end of that revised useful life.

LE elects Approach 1 in Question 6.5.70. Therefore, amortization of the top floor ROU asset over the remaining expected useful life of two years from the decision date occurs on a straight-line basis, while the lease liability continues

to be accreted over the remainder of the five-year lease term in the same manner as before the decision date.

Yr.	Lease liability carry. amt.				ROU asset carry. amt.			Single lease cost <sup>4</sup>
	Beg. bal.	Lease liab. accr <sup>1</sup>	Pmt. <sup>2</sup>	End. bal.	Beg. bal.	ROU asset amort. <sup>3</sup>	End. bal.	
2	\$(807)	\$(48)	\$233	\$(622)	\$807	\$(404)	\$403	\$452
3	(622)	(37)	233	(426)	403	(403)	-	440
4	(426)	(26)	233	(219)	-	-	-	26
5	(219)	(14)	233	-	-	-	-	14

Notes:

- Calculated as beginning balance of lease liability multiplied by incremental borrowing rate: Year 2 =  $\$807 \times 6\%$ , Year 3 =  $\$622 \times 6\%$ , etc.
- $\$233 = (\$1,165 / \$5,000) \times \$1,000$ .
- Calculated as balance of ROU asset at beginning of Year 2 divided by remaining expected useful life:  $\$807 / 2$  years.
- The single lease cost for an operating lease is generally calculated so that the remaining cost of the lease is allocated over the remaining lease term on a straight-line basis. As of the decision date, amortization of the ROU asset is no longer calculated so as to result in a straight-line total lease cost.

### **Account for remainder of building separate lease component**

Accounting for the lease component for the remainder of the building from the decision date to the end of the lease term is as follows; this assumes there are no modifications to the lease, no reassessment events resulting in remeasurement and no impairments of the ROU asset.

Yr.	Lease liability carry. amt.				ROU asset carry. amt.			Single lease cost <sup>4</sup>
	Beg. Bal.	Lease liab. accr <sup>1</sup>	Pmt. <sup>2</sup>	End. bal.	Beg. bal.	ROU asset amort. <sup>3</sup>	End. bal.	
2	\$(2,658)	\$(159)	\$767	\$(2,050)	\$2,658	\$(608)	\$2,050	\$767
3	(2,050)	(123)	767	(1,406)	2,050	(644)	1,406	767
4	(1,406)	(84)	767	(723)	1,406	(683)	723	767
5	(723)	(44)	767	-	723	(723)	-	767

Notes:

- Calculated as beginning balance of lease liability multiplied by incremental borrowing rate: Year 2 =  $\$2,658 \times 6\%$ , Year 3 =  $\$2,050 \times 6\%$ , etc.
- $\$767 = (\$3,835 / \$5,000) \times \$1,000$ .
- Calculated as the difference between the single lease cost and the lease liability accretion: Year 2 =  $\$767 - \$159$ , Year 3 =  $\$767 - \$123$ , etc.
- The single lease cost is calculated as lease cost for Years 2–5 divided by remaining lease term:  $\$3,068 / 4$  years. The  $\$3,068$  is calculated using the allocated portion of total lease payments:  $(\$3,835 / \$5,000) \times 1,000 \times 4$ .



## Question 6.5.90

**Accounting for the sublease of a portion of a single underlying asset****How should a lessee account for the sublease of a portion of a single underlying asset?**

**Background:** For purposes of this question, a lessee has leased an entire office building with five floors and accounted for that lease as a single separate lease component. Partway through the lease term, the lessee commits to a plan to sublease one of the five floors. In other words, the lessee will sublease a portion of what it has previously accounted for as a single unit of account.

**Interpretive response:** We believe the lessee should undertake the following steps to account for the sublease of a portion of a single underlying asset.

**1. Evaluate impairment of the asset group**

The lessee continues to evaluate impairment under Topic 360 at the same asset group level after committing to the plan to sublease as before committing to the plan (see Question 6.5.60).

However, committing to the sublease plan (i.e. at the decision date) may constitute a triggering event – e.g. if the lessee believes it is likely to incur a loss on the sublease or based on other economic facts and circumstances associated with the lessee's decision to sublease. This would require an assessment of possible impairment for the larger asset group to which the existing ROU asset belongs. That assessment, as well as the recognition of any impairment loss, follows the guidance in Topic 360. An impairment indicator associated with a portion of an ROU asset may not signify a need to test the entire asset group for impairment. A lessee should consider the significance of the portion of the ROU asset affected by the sublease plan to the asset group as a whole, and the circumstances leading to the sublease decision, before concluding the asset group needs to be tested for impairment.

If the asset group is not impaired, there is no basis in Topic 360 or Topic 842 to immediately write down the carrying amount of the existing ROU asset.

**2. Reevaluate the unit of account**

A decision about whether the right to use the portion of the underlying asset that will be subleased should be separated from the larger, existing ROU asset covering the lessee's right to use the entire underlying asset is important because it determines the go-forward accounting described in Step 3.

At the earlier of the cease-use date and sublease inception ('earlier of' date), we believe the lessee should evaluate why the existing, single separate lease component is a single unit of account. The lessee should determine whether this is the case:

- because there was only a single separate lease component when it was assessed in accordance with paragraph 842-10-15-28 (see section 4.1); or instead

- because the lessee in effect applied a portfolio approach (see section 5.8) – i.e. accounted for multiple separate lease components as a single separate lease component.

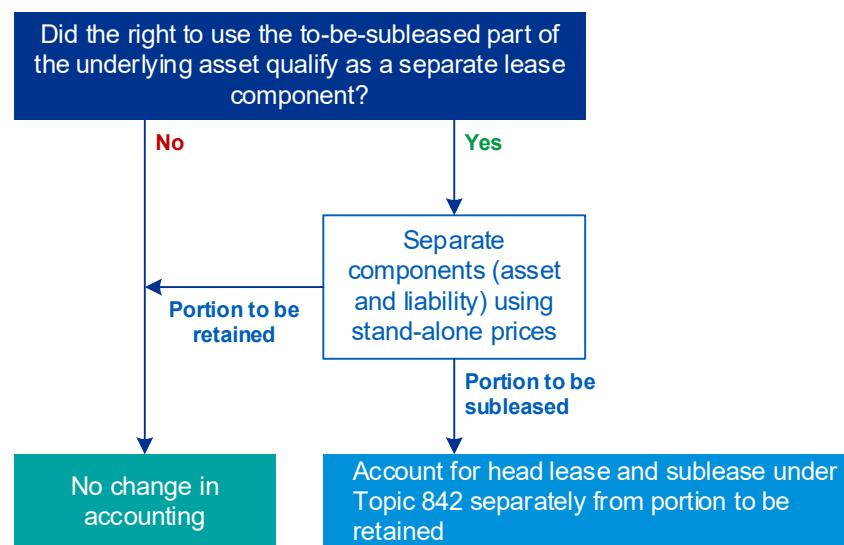
As a practical matter, the lessee may not have previously evaluated this question. For example, the lessee may not have assessed, in deciding to account for the lease of the multi-floor building as a single unit of account, whether the building was a single separate lease component or multiple separate lease components. The assessment may have had no perceived accounting effect at that time. However, at the ‘earlier of’ date, we believe the lessee needs to evaluate this question to properly account for both the head lease and the sublease going forward.

This assessment undertaken at the ‘earlier of’ date is based on the facts and circumstances that existed when this evaluation previously would have taken place, and does not take into account subsequent changes in circumstances – e.g. the changed market desirability of a particular floor of an office building.

In reevaluating the unit of account for the head lease, we believe the lessee’s ability to enter into the sublease for a portion of the underlying asset separately suggests that the right to use that portion of the underlying asset previously would have met the criteria to be a separate lease component. An exception may arise, for example, if there have been substantial modifications to the underlying asset (e.g. converting a warehouse into a multi-story office building) after the date that evaluation would have taken place.

### 3A. Determine go-forward accounting: Topic 360

The reevaluation of the unit of account when only a portion of the underlying asset will be subleased makes the analysis of the go-forward accounting more complex. The following diagram summarizes the additional step in the process, which is explained in detail in the discussion that follows.



#### No separation required (single separate lease component previously)

If, upon evaluation in Step 2, there was only a single separate lease component, no portion of the existing ROU asset (or lease liability) should be separated into

its own unit of account for the right to use the to-be-subleased portion of the underlying asset.

As a result, unless the sublease is for a significant portion of the underlying asset, it is unlikely that entering into the sublease or ceasing use of the portion of the underlying asset that will be subleased (e.g. the floor of the building in the background example) will trigger a change in asset grouping.

Entering into the sublease or ceasing use of the portion of the asset that will be subleased may constitute a triggering event, requiring an impairment assessment of the asset group. This may be in addition to a triggering event identified in Step 1. For example, either of these events may be an additional triggering event if the terms of the executed sublease are less favorable, or expectations about the lessee's ability to sublease the asset have deteriorated, from what was anticipated in Step 1.

***Separation required (right to use the to-be-subleased portion of the underlying asset was a separate lease component previously)***

If the right to use the to-be-subleased asset previously met the criteria to be a separate lease component, a portion of the existing ROU asset reflecting that separate lease component should be separated from the existing ROU asset. A portion of the existing lease liability should also be allocated to the newly separate lease component.

We believe the lessee should allocate the carrying amount of the existing ROU asset and lease liability to (1) the new, separate lease component (i.e. the right to use the portion of the underlying asset that will be subleased), and (2) the separate lease component that reflects the remainder of the original lease, on a relative stand-alone price basis.

Because Topic 842 does not address allocation in this situation, we believe a lessee could base the relative stand-alone price allocation on either:

- the stand-alone prices the lessee would have determined for the two separate lease components had they been previously accounted for separately (historical stand-alone prices); or
- the stand-alone prices of the two separate lease components at the earlier of (1) the cease-use date and (2) sublease inception based on the remaining lease term and the then-current facts and circumstances – e.g. current stand-alone prices (current stand-alone prices).

Next, the lessee should reassess its Topic 360 asset grouping in accordance with Question 6.5.60. The lessee should assess whether the new, separate ROU asset (and related assets such as leasehold improvements) is its own asset group (as will frequently be the case for a subleased ROU asset) or part of an asset group that is different from its previous group.

Entering into the sublease or ceasing use of the to-be-subleased portion of the underlying asset may constitute a triggering event for the asset group that contains the newly separate ROU asset, requiring an impairment assessment under Topic 360. For example, if the new ROU asset is its own asset group, or the predominant asset in the group (e.g. a retail space ROU asset when the asset group is the store), either of the following would likely constitute a triggering event:

- entering into a loss-making sublease; or
- ceasing use of the asset without a sublease in place if facts and circumstances at the cease-use date call into question the lessee's ability to obtain a favorable sublease.

### 3B. Determine go-forward accounting: Topic 842

Similar to the go-forward accounting under Topic 360, the go-forward accounting under Topic 842 depends on the conclusion reached in the assessment of the unit of account.

#### **No separation required (single separate lease component previously)**

If the existing separate lease component was previously a single separate lease component, the lessee accounts for the head lease after the cease-use date or sublease inception in the same manner as any other lease, which includes recognizing any Topic 360 impairment loss identified in Step 3A and following the post-impairment lease accounting guidance. Accounting for the sublease would follow the guidance in chapter 8.

#### **Separation required (right to use the to-be-subleased portion of the underlying asset was a separate lease component previously)**

If the right to use the to-be-subleased asset previously met the criteria to be a separate lease component, the newly separate ROU asset and lease liability are accounted for from the separation date (i.e. the 'earlier of' date) in the same manner as any other lease of a lessee, which includes recognizing any Topic 360 impairment loss identified in Step 3A and following the post-impairment lease accounting guidance. Accounting for the sublease would follow the guidance in chapter 8.

The lessee's accounting for the separate lease component that reflects the remainder of the original lease is accounted for from the separation date in the same manner as any other separate lease component.



#### Example 6.5.50

##### **Sublease of a portion of a leased building**

Lessee LE enters into a contract with Lessor LR for the right to use a five-story office building for five years with no renewal options. The right to use the building is a lease and there are no other components of the contract. There have been no modifications to (or remeasurements of) the lease.

The following facts are relevant at the lease commencement date.

Lease payments (gross lease):	Fixed payments of \$1,000 per year in arrears
LE's incremental borrowing rate:	6% (the rate implicit in the lease cannot be readily determined)
Lease liability recognized: <sup>1</sup>	\$4,212
ROU asset recognized: <sup>2</sup>	\$4,212

## Notes:

1. Calculated as the present value of the five lease payments of \$1,000, discounted at the incremental borrowing rate of 6%.
2. Calculated as the initial measurement of the lease liability because there are no initial direct costs, prepaid lease payments or lease incentives received.

LE appropriately classified the lease as an operating lease, because none of the tests for classification as a finance lease were met (see paragraph 6.2.50). LE did not separately account for the implied land element of the lease (see Question 4.1.20) because the accounting effect of doing so would have been insignificant – i.e. the coterminous land and building elements separately would have both been classified as operating leases.

At the beginning of Year 2 (the decision date), when the carrying amount of the lease liability and the ROU asset are both \$3,465, LE decides that it will cease use of the top floor of the building at the end of Year 3 – i.e. two years before the end of the lease term. Between the decision date and the end of Year 3, LE plans to continue using the top floor of the building in the same manner, and as part of the same operation, as before the decision date.

LE intends and has the practical ability to sublease the top floor after it ceases use of it. Consequently, LE does not plan to abandon the ROU asset before the end of the lease term (see Question 6.5.50). At the beginning of Year 3 (i.e. 12 months before LE's planned cease-use date), LE enters into a sublease for the top floor with Sublessee SE for the remainder of LE's head lease term. The sublease will commence immediately following the cease-use date.



The following are the key terms of the sublease.

Lease payments (gross lease):	Fixed payments of \$120 per year in arrears
LE's discount rate for the sublease:	6% (the rate implicit in the sublease cannot be readily determined – see section 8.2.1)
Note: There are no initial direct costs, prepaid lease payments or lease incentives provided.	

### 1. Evaluate whether the asset group is impaired

LE's decision to sublease the top floor of the building does not trigger a reassessment of the asset group that contains the entire building ROU asset, because LE will continue to use the building (including the top floor) until the end of Year 3 in substantially the same manner as before the decision date (see Question 6.5.60). Therefore, the ROU asset remains part of the larger asset group subsequent to the decision date.

LE further concludes that there is no impairment of the asset group that contains the entire building ROU asset based on an appropriate analysis under Topic 360.

However, at the decision date, LE has leasehold improvements on the top floor of the building with a carrying amount of \$200, which LE concludes will no longer provide economic benefits after the cease-use date (end of Year 3); this is because they are specific to LE's use of the top floor and will not provide a benefit associated with the sublease. Consequently, LE concludes that it needs to shorten the remaining useful life of those assets to two years as of the decision date.

## 2. Reevaluate the unit of account

While LE has accounted for the building lease as a single unit of account (one ROU asset and one lease liability) to date, upon entering into the sublease with SE (which precedes the cease-use date), LE concludes that the top floor of the building previously met the criteria to be accounted for as a separate lease component.

- LE could benefit from the top floor on its own – i.e. separate from the other four floors of the building. This is evident because:
  - LE can practically sublease the top floor to a third-party sublessee; and
  - LR and other lessors regularly lease different floors in similar office buildings to unrelated lessees.
- The right to use the top floor is not highly dependent on, nor highly interrelated with, LE's right to use the remainder of the building. At contract inception, the building was already divided into multiple floors such that LR could have granted separate rights to use different floors of the building to multiple lessees or transferred rights to use the different floors to LE with different commencement dates.

## 3A. Determine go-forward accounting: Topic 360

### ***Separate and allocate the existing ROU asset and lease liability to the two separate lease components created by Step 2***

Based on the conclusion reached in Step 2, at the sublease inception date LE separates its lease of the top floor from its lease of the remainder of the office building. LE allocates between the top floor lease component and the lease component for the remainder of the building on a relative stand-alone price basis. In this example, LE elects to use historical stand-alone prices (see Question 6.5.90).

Separate lease component	Stand-alone price	Allocated ROU asset	Allocated lease liability
Top floor	\$1,165	\$ 623 <sup>2</sup>	\$ 623 <sup>2</sup>
Remaining floors	3,835	2,050 <sup>3</sup>	2,050 <sup>3</sup>
<b>Total</b>	<b>\$5,000<sup>1</sup></b>	<b>\$2,673</b>	<b>\$2,673</b>

**Notes:**

1. Because LE is using historical rather than current stand-alone prices, those prices are based on two five-year leases.
2.  $\$623 = (\$1,165 / \$5,000) \times \$2,673$  (carrying amount at beginning of Year 3).
3.  $\$2,050 = (\$3,835 / \$5,000) \times \$2,673$  (carrying amount at beginning of Year 3).

***Reassess Topic 360 asset grouping***

LE concludes that the identifiable cash flows associated with the top floor ROU asset and leasehold improvements and the top floor lease liability are largely independent of the cash flows of other long-lived assets and related liabilities. LE's cash inflows and outflows will principally consist of the sublease payments from SE and head lease payments to LR.

***Assess impairment under Topic 360***

LE concludes that there are no impairment indicators with respect to the asset group that contains the ROU asset for the remaining floors. Therefore, no impairment assessment is undertaken by LE for that asset group as a result of subleasing the top floor of the building.

LE concludes that entering into the loss-making sublease for the top floor of the building and planning to abandon the related leasehold improvements are indicators of impairment for the top floor asset group. LE conducts an appropriate analysis under Topic 360 and concludes that the asset group is impaired by \$320. The impairment charge is allocated to the ROU asset and the leasehold improvements on a pro rata basis using the relative carrying amounts of those assets as follows. [360-10-35-28]

Asset	Pre-impairment carrying amount	Allocated impairment loss	Post-impairment carrying amount
ROU asset	\$623	\$276 <sup>1</sup>	\$347
Leasehold improvements	100	44 <sup>2</sup>	56
<b>Total</b>	<b>\$723</b>	<b>\$320</b>	<b>\$403</b>

**Notes:**

1.  $\$276 = (\$623 / \$723) \times \$320$ .
2.  $\$44 = (\$100 / \$723) \times \$320$ .

***3B. Determine go-forward accounting: Topic 842******Accounting for the top floor lease component***

LE's accounting for the top floor ROU asset and lease liability after the impairment recognized in Step 3A (at sublease inception) is as follows.

Yr.	Lease liability carry. amt.				ROU asset carry. amt.			Single lease cost <sup>4</sup>	Sub-lease inc.
	Beg. Bal.	Lease liab. accr <sup>1</sup>	Pmt. <sup>2</sup>	End. bal.	Beg. Bal.	ROU asset amort. <sup>3</sup>	End. bal.		
3	\$(623)	\$(37)	\$233	\$(427)	\$347	\$(116)	\$231	\$153	\$ -
4	(427)	(26)	233	(220)	231	(116)	115	142	(120)
5	(220)	(13)	233	-	115	(115)	-	128	(120)

## Notes:

1. Calculated as beginning balance of lease liability multiplied by incremental borrowing rate: Year 3 =  $\$623 \times 6\%$ , Year 4 =  $\$427 \times 6\%$ , etc.
2.  $\$233 = (\$1,165 / \$5,000) \times \$1,000$ .
3. Calculated as balance of ROU asset at beginning of Year 2 divided by remaining expected useful life:  $\$347 / 3$  years.
4. The single lease cost for an impaired operating lease is calculated as described in paragraph 6.5.50.

***Accounting for the leasehold improvements in the top floor asset group***

Subsequent to reducing the carrying amount of the leasehold improvements by \$44 in Step 3, LE will continue to depreciate the remaining, post-impairment carrying amount of \$56 over the remaining, shortened useful life for those assets (which is one year between sublease inception and the cease-use date).

***Accounting for the separate lease component for the remainder of the building***

Accounting for the lease component for the remainder of the building from sublease inception to the end of the lease term is as follows (assuming no lease modifications, no reassessment events resulting in remeasurement, and no impairments of the ROU asset).

Yr.	Lease liability carry. amt.				ROU asset carry. amt.			Single lease cost <sup>4</sup>
	Beg. bal.	Lease liab. accret. <sup>1</sup>	Pmt. <sup>2</sup>	End. bal.	Beg. bal.	ROU asset amort. <sup>3</sup>	End. bal.	
3	$(\$2,050)$	$(\$123)$	$\$767$	$\$(1,406)$	$\$2,050$	$\$(644)$	$\$1,406$	$\$767$
4	$(1,406)$	$(84)$	$767$	$(723)$	$1,406$	$(683)$	$723$	$767$
5	$(723)$	$(44)$	$767$	$-$	$723$	$(723)$	$-$	$767$

## Notes:

1. Calculated as beginning balance of lease liability multiplied by incremental borrowing rate: Year 3 =  $\$2,050 \times 6\%$ , Year 4 =  $\$1,406 \times 6\%$ , etc.
2.  $\$767 = (\$3,835 / \$5,000) \times \$1,000$ .
3. Calculated as the difference between the single lease cost and the lease liability accretion: Year 3 =  $\$767 - \$123$ .
4. The single lease cost is calculated as lease cost for Years 3–5 divided by remaining useful life:  $\$2,301 / 3$  years. The \$2,301 is calculated using the allocated portion of total lease payments:  $(\$3,835 / \$5,000) \times 1,000 \times 3$ .



## Question 6.5.100

**Topic 420 and non-lease component costs****Should non-lease component costs be accrued under Topic 420 when the lessee ceases use of the underlying asset?**

**Background:** Costs to terminate a lease are outside the scope of Topic 420 (exit or disposal cost obligations) after the adoption of Topic 842. [420-10-05-2(b), 15-3b]

Before the adoption of Topic 842, a lessee in an operating lease that ceased use of the underlying asset would accrue the remaining lease payments as of the 'cease-use date' (the date the entity ceased using the right conveyed by the contract), net of amounts it could obtain from a sublessee if it chose to sublease the asset. The lessee's accrual included other fixed and estimated variable costs connected to the lease (e.g. future property tax, insurance and maintenance costs) that would continue to be incurred after the cease-use date without remaining economic benefit to the lessee.

**Interpretive response:** It depends on whether the lessee has elected the practical expedient to not separate lease and non-lease components (see section 4.4.1).

**Lessee elects the non-separation practical expedient**

When a lessee elects the non-separation practical expedient, the lease component and the combined non-lease components are accounted for as a single *lease* component (see paragraph 4.4.30). Therefore, all lease component, non-lease component and non-component (e.g. property tax and insurance) costs are accounted for as fixed or variable *lease* costs.

As outlined in the background, after the adoption of Topic 842, costs to terminate a lease are outside the scope of Topic 420. This includes costs related to the lease that will continue to be incurred without economic benefit to the lessee, such as property tax, insurance or common area maintenance costs. Therefore, none of those costs are accrued at the cease-use date after adopting Topic 842.

**Lessee does not elect the non-separation practical expedient**

Costs to terminate a non-lease component (e.g. a service or the delivery of a supply of goods) remain in the scope of Topic 420. Therefore, at the cease-use date the lessee will accrue:

- fixed costs allocable to the non-lease component; and
- estimated variable payments allocable to the non-lease component.

Allocation of fixed and variable payments to the lease and non-lease components in this context occurs on the same basis as the 'consideration in the contract' was allocated to those components.

Fixed costs and the portion of estimated variable payments allocable to the lease component are outside the scope of Topic 420, and are *not* accrued at the cease-use date.

Example 6.5.60 illustrates this accounting.



### Example 6.5.60

#### Applying Topic 420 to a non-lease component

Lessee LE enters into a five-year retail space lease that includes common area maintenance (CAM), a non-lease component. There are no other components of the contract. The lease is a net lease (see paragraph 4.2.110).

Lease payments:	Base rent payments of \$1,000 per year in arrears
Variable payments:	Proportionate share of property taxes, insurance and CAM costs
Renewal options:	None
Termination/purchase options:	None
LE's incremental borrowing rate:	5% (the rate implicit in the lease cannot be readily determined)
Initial direct costs (LE):	None
Lease/CAM stand-alone price allocation:	90/10

At the end of Year 2, LE ceases use (as defined in Topic 420) of the leased space. At that date, the following facts are relevant.

Estimated variable CAM costs per year for remaining 3 years of the lease:	\$400
Estimated variable property tax/insurance costs per year for remaining 3 years of the lease:	\$100
Credit-adjusted risk-free rate:	6%

#### Scenario 1: LE elected the non-separation practical expedient

No costs are accrued under Topic 420 at the cease-use date. The (1) base rent and (2) expected variable property tax, insurance and CAM costs are accounted for as lease payments and variable lease payments, respectively. Therefore, they are all considered costs to terminate a lease and are outside the scope of Topic 420.

#### Scenario 2: LE did not elect the non-separation practical expedient

CAM is accounted for as a non-lease component, separate from the lease. Therefore, the base rent and all of the variable payments are allocated between the lease and the CAM (90% to the lease, 10% to the CAM).

At the cease-use date, LE recognizes a liability for CAM at fair value under Topic 420. The liability incorporates the portion of both of the following that is allocable to the CAM, based on the 90/10 stand-alone price allocation:

- the remaining unpaid base rent payments; and
- the estimated variable payments for property taxes, insurance and CAM.

LE measures the fair value of the liability based on the estimated future cash flows, discounted using a credit-adjusted risk-free rate (6%).

The following table shows the calculation of the cease-use date Topic 420 liability.

Payments	Estimated costs to be incurred <sup>1</sup>	Amount allocated to CAM <sup>2</sup>	Topic 420 liability <sup>3</sup>
CAM costs	\$1,200	\$120	\$107
Property taxes and insurance	300	30	27
Base rent	3,000	300	267
<b>Total</b>	<b>\$4,500</b>	<b>\$450</b>	<b>\$401</b>

Notes:

1. Annual estimated costs (see facts table above) × 3 years remaining in the lease.
2. 10% of the total costs to be incurred.
3. The portion of the three annual payments allocated to CAM, discounted using the credit-adjusted risk-free rate of 6%.

### 6.5.3 Interaction with Topic 360 when ROU asset is part of a disposal group that is held for sale

6.5.190 Topic 360 (section 360-10-45) requires assets within its scope to be classified as 'held for sale' when specified criteria are met. [360-10-45-9 – 45-12]

6.5.200 Section 360-10-35 provides guidance on: [360-10-35-37 – 35-45]

- the accounting for long-lived assets classified as held for sale;
- measuring disposal gains and losses; and
- measuring long-lived assets that are reclassified to held and used.

6.5.210 Topic 842 explicitly requires that ROU assets (finance and operating) be assessed for impairment under Topic 360 (see section 6.5.1). The FASB further states in the basis for conclusions to ASU 2016-02, "The right-of-use asset is a long-lived, nonfinancial asset and, therefore, should be within the scope of the Impairment or Disposal of Long-Lived Assets Subsection of Topic 360," which includes the guidance on assets held for sale in paragraphs 360-10-35-37 – 35-45. [842-20-35-9, ASU 2016-02.BC255]

6.5.220 The following questions address when an ROU asset is held for sale and how to account for a lease when that is the case.



### Question 6.5.110

#### **ROU asset held for sublease – held for sale classification**

### **Is an ROU asset that is being held out for sublease subject to the held for sale guidance in Topic 360?**

**Interpretive response:** No. The basis for conclusions to ASU 2016-02 states the FASB's view that in a head lease-sublease scenario, the head lease ROU asset is not considered to be held for sale. [\[ASU 2016-02.BC115\]](#)

Therefore, we believe that for an ROU asset to be held for sale either:

- the entity's 'plan' must be to find a third party to assume (acquire) the related lease – i.e. relieving the entity of its primary obligation for the lease; or
- it must be part of a disposal group whereby it is expected that the purchaser will assume the lease as part of the purchase of the group – i.e. the purchaser will assume the primary obligation for the lease so that it is terminated from the entity's perspective.



### Question 6.5.120

#### **Lease cost recognition – ROU asset held for sale**

### **Should an ROU asset continue to be amortized while it is held for sale?**

**Interpretive response:** No. Consistent with the guidance for other depreciable or amortizable long-lived assets, an ROU asset should not be amortized while it is held for sale. [\[360-10-35-43\]](#)

#### **Interest/accretion**

While an ROU asset is classified as held for sale, interest (finance leases) and accretion (operating leases) should continue to be recognized. This is because, while Topic 360 states that amortization should cease on an asset that is held for sale, it specifies immediately thereafter that "Interest and other expenses attributable to the liabilities of a disposal group classified as held for sale shall continue to be accrued." [\[360-10-35-43\]](#)

#### **Short-term leases**

Short-term lease cost for unrecognized short-term leases (see section 6.3.1) should continue to be recognized even if the disposal group to which the lease belongs is held for sale. Because there is no ROU asset recognized for the lease, there is nothing subject to the held for sale guidance; therefore, lease cost should continue to be recognized just as it should be for any other executory contract of the disposal group.



## Question 6.5.130

**Subsequent changes – ROU asset held-for-sale reclassified to held-and-used****How should a lessee account for an ROU asset reclassified from held-for-sale back to held-and-used?**

**Background:** For purposes of this question, assume an ROU asset was previously classified as held-for-sale. Subsequently, circumstances arise that result in a change to the plan of sale for the disposal group that contained the ROU asset. Therefore, the ROU asset is reclassified to held-and-used.

**Interpretive response:** An ROU asset reclassified to held-and-used from held-for-sale is measured in the same manner as any other long-lived asset subject to Topic 360. This is regardless of the classification of the underlying lease as finance or operating. See paragraph 6.5.210.

Therefore, an ROU asset that is reclassified from held-for-sale to held-and-used is measured at the lower of: [360-10-35-44]

- its carrying amount before it was classified as held-for-sale, adjusted for any amortization that would have been recognized had the asset been continuously classified as held-and-used; and
- its fair value at the date of the subsequent decision not to sell.

When an ROU asset is reclassified as held-and-used, any adjustment to its carrying amount is reported in the income statement as an impairment charge in continuing operations in the period that the held-for-sale criteria are no longer met. This is consistent with the requirements applicable to other long-lived assets; see Question 4.6.50 in KPMG Handbook, *Discontinued operations and held-for-sale disposal groups*. [360-10-45-7]

**6.6 Lease reassessments (Step 8A)****6.6.1 When to reassess****Excerpt from ASC 842-10****35 Subsequent Measurement****General**

> Lease Term and Purchase Options

**35-1** A lessee shall reassess the **lease term** or a lessee option to purchase the **underlying asset** only if and at the point in time that any of the following occurs:

- a. There is a significant event or a significant change in circumstances that is within the control of the lessee that directly affects whether the lessee is reasonably certain to exercise or not to exercise an option to extend or

- terminate the **lease** or to purchase the underlying asset.
- 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.

**35-2** 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.

> Subsequent Measurement of the Lease Payments

**35-4** A **lessee** shall remeasure the **lease payments** if any of the following occur:

- The **lease** is modified, and that modification is not accounted for as a separate **contract** in accordance with paragraph 842-10-25-8.
- 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).
- There is a change in any of the following:
  - 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.
  - 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.
  - 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 reassessment is required.

## 55 Implementation Guidance and Illustrations

### General

> Implementation Guidance

- > Reassessing the Lease Term and Purchase Options

**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:

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

**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.

6.6.10 A lease reassessment or modification (that is not accounted for as a separate contract) will often result in the remeasurement of the lease liability and the ROU asset. The following diagram provides an overview of the reassessment and modification requirements applicable to lessees, which are explained in this section (reassessments) and in section 6.7 (modifications). Section 6.8A addresses accounting for leases, including reassessment requirements, when in bankruptcy. [842-10-35-4]

Remeasurement of the lease liability and the ROU asset occurs when:				
When do I reassess?	Lease modification not accounted for as a separate contract (see section 6.7)	Change in lease term	Change in assessment of lessee purchase option being exercised	Change in amount probable of being owed by lessee under residual value guarantee
In remeasuring, what do I update:	N/A	Only when there is a triggering event (as defined)	Whenever relevant facts and circumstances change	
Lease payments? <sup>1</sup>	✓	✓	✓	✓
Consideration in the contract?	✓	✓	✓	✓
Allocations of consideration in the contract? <sup>2</sup>	✓	✓	✓	✓
Discount rate?	✓	✓	✓	✗
Lease classification?	✓	✓	✓	✗

## Notes:

1. This includes updating variable lease payments that depend on an index or rate as of the remeasurement date using the remeasurement date index or rate.
2. See Question 6.6.110.

6.6.20 The discussion that follows is based on the diagram in paragraph 6.6.10, and deals with lease reassessments. Lease modifications are discussed in section 6.7.

### ***Reassessment of the lease term or a lessee purchase option***

6.6.30 The lease term and the likelihood of a lessee exercising a purchase option are only reassessed when one of the following occurs. [IAS 16-10-35-1, ASU 2016-02.BC232]

- An event written into the contract obliges the lessee to exercise (or not exercise) an option.
- The lessee elects to exercise an option that it had previously determined it was not reasonably certain to exercise.
- The lessee elects not to exercise an option that it had previously determined it was reasonably certain to exercise.
- A ‘triggering event’.



#### **Example 6.6.08**

#### **Reassessment date – failure to give notice**

Lessee LE leases a building from Lessor LR for a noncancelable period of five years that commenced on January 1, 20X1. The lease automatically renews for a second five-year period starting January 1, 20X6 if LE does not notify LR of its intention to vacate the building on or before June 30, 20X5. At lease commencement, LE was not reasonably certain to extend the lease beyond the noncancelable five-year period. Therefore, the lease term was five years.

Through June 30, 20X5, LE does not notify LR of its intent to end the lease at the end of the noncancelable five-year period. No other reassessment events (see paragraph 6.6.30) have occurred to that point, such that the remaining lease term is six months.

By not submitting notice to LR, LE has, as of June 30, 20X5, enforceably elected to renew the lease for the five-year renewal period (i.e. just as if LE had sent an affirmative renewal confirmation to LR). Therefore, consistent with paragraph 6.6.30, LE reassesses the lease term and concludes the remaining lease term is now five years and six months (i.e. the six-month remaining initial term plus the five-year renewal term). LE remeasures the lease (see section 6.6.2) to reflect that remaining lease term.

It would be inappropriate for LE *not* to reassess the lease term as of June 30, 20X5 in this scenario. LE’s June 30, 20X5 ROU asset and lease liability would be misstated if it continued to reflect only the six-month remaining initial lease term.

6.6.40 A triggering event is a significant event or significant change in circumstances that both: [842-10-35-1, ASU 2016-02.BC232]

- is within the lessee's control; and
- directly affects the assessment of whether the lessee is reasonably certain to exercise an option.

6.6.50 The following are examples of triggering events. [842-10-55-28, ASU 2016-02.BC232]

Constructing significant leasehold improvements <sup>1</sup>	Subleasing the asset for a period beyond the end of the lease term <sup>2</sup>
Significantly modifying or customizing the asset	Making a business decision directly relevant to option exercise <sup>3</sup>

Notes:

1. The lessee constructs leasehold improvements that are expected to have significant economic value beyond the end of the previously assessed lease term. For example, assume that in Year 6 of the 10-year office space lease in Example 6.3.10, the lessee constructs leasehold improvements that will have significant economic value for 10 years. The construction of those leasehold improvements might make it reasonably certain that the lessee will extend the lease to obtain the remaining economic benefits from those leasehold improvements.
2. For example, subleasing an asset for which the lease term was initially assessed as 15 years (15-year non-cancellable period with two five-year renewal options), to a sublessee for a non-cancellable period of 25 years or subleasing it for the remainder of the head lease term with renewal options that the sublessee is reasonably certain to exercise. In those cases, fulfilling the sublease makes it reasonably certain that the entity will exercise its renewal options on the head lease.
3. For example, extending the lease of a complementary asset or disposing of an alternative asset.

6.6.60 Changes in market-based factors (e.g. changes in the real estate market) do not, in isolation, trigger the reassessment of a lessee option – i.e. to extend or terminate the lease or purchase the underlying asset because they are generally not within the lessee's control. [842-10-55-29, ASU 2016-02.BC232]



### Observation

**Option reassessment guidance will impact processes and controls**

6.6.70 The reassessment requirements should not require lessees to continually reassess the lease term and lessee purchase options. However, given the pervasive and potentially material effect that lease reassessments could have on a lessee's financial statements, lessees will need to implement new processes and controls to address the new risk points. [ASU 2016-02.BC232]

6.6.80 These include processes and controls to monitor and, where relevant, account for (1) significant events or changes in circumstances (i.e. triggering events) within their control; (2) the exercise of options or a decision taken not to exercise an option; and (3) events specified explicitly in the contract that require

the lessee to exercise (or not to exercise) an option. This effort likely will need to involve cross-functional coordination to ensure timely identification of events requiring revisions to lease accounting.



## Question 6.6.05

### Identifying business decision reassessment triggering events

#### What constitutes a 'business decision' reassessment triggering event?

**Background:** Making a business decision *that is directly relevant to the lessee's ability to exercise or not to exercise an option* – e.g. extending the lease of a complementary asset or disposing of an alternative asset – is an example of a triggering event that requires a lessee to reassess the lease term or a lessee purchase option over the underlying asset (see paragraphs 6.6.40 and 6.6.50). [842-10-55-28(c)]

**Interpretive response:** We believe that for a lessee business decision (e.g. to renew or to terminate a lease) to trigger a lease term or purchase option reassessment, that decision must not be reversible without substantive economic cost (or consequence) to the lessee, because:

- Absent that, the decision is no more than a changed expression of management's intent. Management intent does not determine the initial lease term or assessment of a lessee purchase option under Topic 842, and therefore it also should not drive a change to either of those. The assessment of lease term and lessee purchase options is based on economic factors, such that only a significant event or significant change in circumstances that changes the economics of the lease to the lessee can trigger a reassessment. [IASU 2016-02.BC193]
- Only a decision that is either not reversible at all, or that can be reversed only by incurring a substantive economic cost (or consequence), will be '*directly relevant to the lessee's ability to exercise or not to exercise*' the renewal, termination or purchase option in question.

#### Example business decisions

The following table gives example lessee business decisions, and evaluates whether each one constitutes a reassessment triggering event.

Scenario	'Business decision' triggering event? (Yes/No)	Explanation
Lessee provides legal notification to Lessor that it will terminate (or not renew) the lease.	Yes	Lessee's termination notification is legally enforceable. Lessee has given up its right to use the leased property after the termination date, and Lessor can now enter into a contract with a

Scenario	'Business decision' triggering event? (Yes/No)	Explanation
		replacement tenant. Lessee cannot reverse its decision without Lessor's agreement.
Lessee CEO decides and communicates internally that they have decided to close the location, but Lessee will not notify Lessor until 60 days before vacating the premises (the date by which it is legally required to do so to terminate the lease).	No	Absent any other actions, the CEO's decision and internal communication can be reversed without economic cost or consequence to Lessee.
Lessee adds space to and extends the term of an existing lease for another property to accommodate vacating the leased property.	Yes	Lessee's modification (expansion and extension) to its other property lease is non-cancellable. Therefore, if Lessee reverses its decision to cease use of the leased property, it would either: <ul style="list-style-type: none"> <li>— be required to negotiate another amendment with the lessor of the other property; or</li> <li>— incur redundant occupancy costs.</li> </ul>
Lessee communicates publicly (e.g. press release) its intent to exit multiple properties. The leased property is part of Lessee's plan, but the property is not identified in the public communication and Lessee is exiting only a fraction of its total leased properties under the plan.	No	Identifying the property might have carried an economic cost or consequence – e.g. making Lessee's employees and Lessor aware of Lessee's plan. However, because the communication does not identify the leased property, in itself it does not create an economic cost or consequence for Lessee if it changes its plan for the specific property.



### Example 6.6.10 Is reassessment required?

Lessee LE leases a building, to be used as a retail store, from Lessor LR for a non-cancellable period of five years. The following facts are relevant at the lease commencement date.

Renewal options:	Two options for 5 years each (at market rentals)
Purchase option:	\$250,000 (estimated fair value) at the end of Year 5, increasing by 1% a year if LE exercises one or both of the renewal options
Transfer of ownership:	No

At lease commencement, LE concludes that it is not reasonably certain to exercise either of the five-year renewal options or the purchase option. Therefore, the lease term at commencement is five years.

### Scenario 1: Change in market value of underlying asset

In addition to the basic facts for this example, assume that at the end of Year 2 of the five-year lease term, the city announces a major renovation of the downtown neighborhood in which the building is located. The renovation is expected to significantly increase both (1) the fair value of the building and (2) consumer traffic in the area.

As a result, the exercise price of the purchase option is expected to be significantly lower than the fair value of the building, and the rental payments during the two renewal periods are expected to be at a bargain compared to market rentals. The increased consumer traffic is also expected to substantially affect the revenues that will be generated by the retail store once the renovation is complete.

In this scenario, LE does not reassess either the lease term (i.e. consider whether it is now reasonably certain to exercise one or both of the renewal options) or the purchase option. This is because the significant event and significant change in circumstances related to the building were not within the control of LE. The city, not LE, undertook the action that is significantly changing the circumstances surrounding this lease. In addition, market-based factors (e.g. a change in the real estate market) not within the control of the lessee do not, in isolation, trigger a reassessment of a lessee option.

### Scenario 2: Change in business climate

In addition to the basic facts for this example, assume the following.

- LE is operating a retail store that is unproven in the marketplace where the leased building is located – e.g. it has not been tested in this part of the country).
- By the end of Year 3 of the lease term, the store is far exceeding initial expectations and has developed a devoted customer base in the neighborhood for a variety of reasons that were validly not anticipated at lease commencement. It is not expected that LE could relocate to another location within the city and replicate its results at the present location. Therefore, LE concludes that it is reasonably certain to exercise at least the first five-year renewal option.

Despite the fact that LE now views itself as reasonably certain to exercise the first five-year renewal option, unless LE actually exercises that option at the end of Year 3, LE does not reassess the lease term based on the facts presented. The success of the retail store is not a significant event or significant change in

circumstances undertaken by LE – LE is merely operating the retail store in this new location successfully.

### Scenario 3: Business decision that affects lessee's economic reasons to exercise (or not to exercise) an option

In addition to the basic facts for this example, assume the following.

- LE has been fulfilling all of its online sales orders from this retail location and one other retail location. None of its other retail locations engage in online fulfillment or are equipped, without significant expense, to do so.
- At the end of Year 4 of the lease term, LE terminates its lease of the other retail location engaged in online fulfillment activities and vacates that building. Between the end of Year 4 and the end of the lease term for this retail store, LE will be unable to relocate and re-create its fulfillment activities absent significant cost (either to move to an outsourcing model or pay a premium to acquire the proper space needed and have it customized).

The decision to terminate the lease of the other retail location was within the control of LE and affects LE's economic reasons to exercise (or not exercise) the renewal options related to the building lease in this example. Therefore, LE reassesses the lease term of the building lease in this example.

Upon reassessment, based on the facts presented and as a result of making the business decision to terminate the lease of the other location, LE concludes that it is now (at the end of Year 4) reasonably certain to exercise the first five-year renewal option. LE will remeasure the lease payments based on a revised remaining lease term of six years from the reassessment date.



#### Question 6.6.10 Reassessment of a lessee option

### Will a reassessment of a lessee option always result in a remeasurement of the lease liability under Topic 842?

**Interpretive response:** No, not always. A reassessment will result in a remeasurement of the lease payments when the event leading to the reassessment is one of the following. [842-10-35-1]

- An event written into the contract obliges the lessee to exercise (or not to exercise) an option.
- The lessee elects to exercise an option even though it had previously determined that it was not reasonably certain to do so.
- The lessee elects not to exercise an option even though it had previously determined that it was reasonably certain to do so.

In each of those cases, the event will change the lease term or the reasonably certain assessment of a purchase option.

However, because reasonably certain is a high threshold of assurance (see section 5.2), a significant event or significant change in circumstances (within

the control of the lessee and directly related to the assessment of the lessee option) – i.e. a ‘triggering event’ – may not result in a change to the previous assessment of whether the lessee is reasonably certain to exercise an option (or not exercise a termination option). Although reassessments will not always result in a formal change to the assessment of lessee option exercise, we believe they usually will, particularly if the triggering event is one of the examples in Topic 842 (see paragraph 6.6.50).



### Question 6.6.20

#### Impairment as a reassessment trigger

### Does a Topic 360 ROU asset impairment triggering event automatically trigger a reassessment of the lease term or likelihood of lessee purchase option exercise?

**Background:** Consider a scenario in which Lessee LE leases a building, to be used as a retail store, from Lessor LR for a non-cancellable period of 10 years. The lease includes one 5-year renewal option. At lease commencement, LE concludes that it is reasonably certain to exercise the renewal option, and therefore the lease term is 15 years.

By Year 9, the retail location is performing poorly for reasons that were not anticipated at lease commencement, and LE decides that it will not exercise its renewal option. However, LE takes no action to vacate the retail location and decides that it will not communicate its decision to vacate to the lessor until it is required to do so, which is 60 days before the end of the 10-year non-cancellable period of the lease.

The poor performance of the retail location is an impairment triggering event under Topic 360. If LE tests the retail store asset group for impairment at the beginning of Year 9 (see section 6.5.1) without reassessing the lease term, a significant impairment loss may be recognized. [360-10-35-21]

In this situation, the question arises about whether LE should reassess the lease term at the beginning of Year 9 before recognizing an impairment loss on the asset group.

- If LE reassesses the lease term at the beginning of Year 9, it may conclude that the remaining lease term is only two years (rather than seven years). In that case, the lease term reduction would reduce the carrying amount of the ROU asset significantly, which might significantly reduce (or even eliminate) impairment of the retail location asset group.
- Conversely, if LE does not reassess the lease term, it may recognize:
  - a significant impairment of the retail location asset group (including the ROU asset) at the beginning of Year 9; and
  - a gain, potentially significant, when it formally elects not to exercise the 5-year renewal option (i.e. notifies the lessor). The gain results from reducing the lease liability, but having no (or a reduced) ROU asset to

correspondingly reduce at that point in time (see paragraph 6.6.170).  
[842-20-35-4]

**Interpretive response:** No. Under Topic 842, a reassessment triggering event must be a significant event or change in circumstances *within the lessee's control* (see paragraph 6.6.40). A change in market-based factors does not, in isolation, trigger a reassessment of the lease term or likelihood of lessee purchase option exercise (see paragraph 6.6.50).

Topic 360 asset impairment triggering events can, in contrast, be solely market-based and not within the control of the asset owner. For example, Topic 360 impairment triggers include market-based decreases in the fair value of a long-lived asset, or a regulatory change or economic downturn entirely outside the control of the asset owner. Such events or changes in circumstances, which are outside the control of the lessee (owner of the ROU asset), do not trigger a reassessment of the lease term or likelihood of lessee purchase option exercise. [360-10-35-21]

Therefore, a Topic 360 impairment triggering event may or may not also trigger a lease reassessment, depending on the nature of the event.

For example, a significant change by the lessee in the extent or manner in which it is using the underlying asset is an example of both a Topic 360 triggering event *and* a significant event within the control of the lessee that directly affects whether it is reasonably certain to exercise a renewal or purchase option. [360-10-35-21(b), 842-10-55-28(c)]

In contrast, the poor performance of the retail location in the background that triggered the Topic 360 impairment analysis is a market-based condition outside LE's control. Because LE has taken no action to vacate the retail location, LE does not reassess the lease term at the beginning of Year 9. Instead, LE's communication to LR of non-renewal of the lease 60 days before the end of the non-cancellable lease period will be the next trigger for LE to reassess the lease term (absent another trigger between the beginning of Year 9 and LE's communication to LR). At that point, LE will:

- remeasure the lease liability – reducing it to reflect that there will be only 60 days left in the reassessed lease term; and
- recognize a significant offsetting gain because the ROU asset will already have a carrying amount of zero (or near zero; see next paragraph).

Because LE does not intend to sublease the location after the end of Year 10, LE treats the plan not to renew the lease as a plan to abandon the ROU asset that will remain at the end of Year 10 (see Question 6.5.50). As outlined in Question 6.5.70, this means that the post-impairment ROU asset (the carrying amount that remains after taking any beginning of Year 9 Topic 360 impairment) will be amortized in a manner that ensures it is amortized to its salvage value (see Question 6.5.33) by the end of Year 10 (when LE will cease use of the location and end the lease).

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### Question 6.6.30

#### Changes to amounts probable of being owed under a residual value guarantee

**Is a lessee only required to reassess amounts probable of being owed under a residual value guarantee upon the occurrence of a triggering event?**

**Interpretive response:** No. Unlike for reassessments of the lease term or lessee purchase options, Topic 842 does not provide specific guidance about when a lessee must reassess amounts probable of being owed under a residual value guarantee. However, the basis for conclusions to ASU 2016-02 suggests that it is the Board's intent for lessees to remeasure the lease payments whenever facts and circumstances change, suggesting that the lease payments should be remeasured for a change in the amount probable of being owed under a residual value guarantee when the previous estimate is no longer accurate (subject to materiality considerations). [\[ASU 2016-02.BC239\]](#)

Therefore, the lease payments may be required to be remeasured, which results in a number of additional accounting steps (see paragraph 6.6.140), whenever there is a change in the estimated residual value of the underlying asset at the end of the lease term that affects the amount payable under a residual value guarantee – typically a decrease in the estimated residual value.

#### **Resolution of a contingency**

6.6.90 The resolution of a contingency on which some or all variable lease payments to be paid over the remainder of the lease are based may be resolved, and result in those payments prospectively meeting the definition of lease payments. For example, if the payments for Years 2–10 of a retail store lease will be based on 10 percent of Year 1 retail store sales, at the end of Year 1 the lease payments for Years 2–10 become fixed payments. In this scenario, a remeasurement of the lease payments is required. This is illustrated in Example 6.6.70. [\[842-10-35-4\(b\), ASU 2016-02.BC238\]](#)



#### Observation

#### Resolution of contingencies

6.6.100 The Board considered scenarios in which entities might attempt to circumvent the lessee ROU asset and lease liability recognition and measurement requirements by initially structuring the lease payments at a nominal amount. For example, lease payments could be set at \$10 for Year 1 of a 10-year lease and then become fixed (or partially fixed) after Year 1 for the remainder of the lease term based on a percentage of Year 1 sales using a leased building, or based on Year 1 production using a piece of leased equipment. [\[ASU 2016-02.BC238\]](#)

6.6.110 Absent this requirement, some stakeholders suggested that the guidance would not require the lessee to reassess the lease payments and

update its lease liability and ROU asset in those scenarios. If so, the lessee might not recognize a meaningful ROU asset or lease liability throughout the lease term even though the terms of the lease would require fixed payments after resolution of the contingency. Therefore, the Board decided to specify that if variability in some or all of the remaining lease payments is resolved, those amounts prospectively meet the definition of lease payments and should be reflected, from that point forward, in the ROU asset and the lease liability.

[ASU 2016-02.BC238]



#### Question 6.6.40

##### **Variable lease payments that depend on an index or rate and resolution of a contingency**

**Is a change in a reference index or rate that will affect variable lease payments that depend on an index or rate the resolution of a contingency that requires remeasurement of the lease by the lessee?**

**Interpretive response:** No. The guidance on the resolution of contingencies does not apply to variable lease payments that depend on an index or rate, even when the periodic lease payments increase based on the change in CPI, and under the terms of the lease the periodic lease payments will never decrease after they have increased (i.e. even if CPI were to decrease). The payment increase linked to the change in CPI is not captured by this general contingency guidance. Rather, the guidance applies only to situations related to all other types of variable lease payments (e.g. those related to usage or performance of the underlying asset). The Board amended Topic 842 to make this explicit in the guidance in ASU 2018-10. [842-10-35-4(b), ASU 2016-02.BC238]

However, if remeasurement occurs for another reason, variable lease payments that depend on an index or rate are updated to use the index or rate as of the remeasurement date. See section 5.4.1 for further discussion of variable lease payments that depend on an index or a rate.



#### Question 6.6.50

##### **Lessee accounting for reimbursements of capital replacements and repairs**

**How should a lessee account for its obligation to reimburse the lessor for a capital replacement or repair that is not a promised good or service?**

**Background:** A lessor frequently has the contractual right to pass through costs of capital replacements or repairs to its tenants. For example, if a lessor installs a new roof on its property, the tenants may be required to reimburse the lessor for those costs, even if the new roof is not a promise made to any one of the tenants (see Question 4.2.25).

A common reimbursement structure is for tenants to reimburse the lessor consistent with the useful life of the replacement/repair and consistent with the lessee's proportionate right to use the property.

It is also common that the lessee's reimbursement obligation ends if the lease expires. In contrast, if the lessee early terminates the lease, the lessor often has the right to recover the amounts it would have obtained from the lessee related to the capital replacement/repair over the remainder of the lease term.

**Interpretive response:** When the lessor completes the capital replacement or repair and the cost of that replacement/repair to be borne by the lessee becomes known, we believe the lessee should treat this as a resolution of a contingency remeasurement event (see paragraphs 6.6.90 and 6.6.140 – 150).

In this case, consistent with other similar events, the contingent event of the lessor completing the capital replacement/repair results in additional fixed payments being due under the lease. The lease liability should be remeasured to capture those additional fixed payments – i.e. the portion thereof allocable to the lease if there are non-lease components of the contract.

For example, Lessee LE leases 10% of a shopping center's available retail space for 10 years. At the beginning of Year 2, Lessor LR installs a new \$450,000 roof on the shopping center that has a 15-year useful life. Under the terms of the lease, LE will reimburse LR \$3,000 per year for the remaining 9 years of the lease term (\$27,000 total):  $(\$450,000 \text{ total cost} / 15 \text{ years}) \times 10\% \text{ occupancy}$ . The lease liability is remeasured to reflect the additional, fixed payments when those payments become known.

Example 6.6.70 illustrates a resolution of a contingency remeasurement and the post-remeasurement accounting for that lease. Question 7.4.20 addresses lessor accounting for capital replacement/repair reimbursements.



## Question 6.6.60

### Co-tenancy clauses – lessee

#### How should a lessee account for a co-tenancy clause that reduces the lessee's rent when it is triggered?

**Background:** Many retail leases include co-tenancy clauses that reduce the tenant's contractual rent if, for example, a key (or anchor) tenant (e.g. a department or 'big box' store) or a certain number of tenants vacate the property. Typically, these clauses stipulate that the tenant must resume paying the contractual rent either after a specified period of time or when the co-tenancy event is cured (e.g. a new anchor tenant occupies the relevant space vacated by the previous anchor tenant).

Key tenants and a minimum level of overall occupancy help to draw customer traffic to retail properties such as shopping malls. Therefore, the presence of one or more key tenants and/or a high level of overall occupancy of a retail property generally benefits all tenants and is an important consideration for a lessee when deciding where to lease a retail space (and how much the lessee

is willing to pay in rent). Co-tenancy clauses serve to protect lessees from a potential drop in sales when a key tenant vacates its space or overall occupancy of the retail property declines.

Under an example co-tenancy clause, the lessee's fixed rental payments for a five-year retail space lease (e.g. \$1,000 per year in arrears) may convert to a payment based solely on a percentage of the lessee's sales from the retail space (e.g. 5% of sales) for a specified period or until the co-tenancy event is cured. In that way, the lessee and the lessor share the risk that the co-tenancy event will adversely affect the lessee's sales from the leased retail space.

**Interpretive response:** At lease commencement, we believe the lessee's accounting for the lease should not consider a co-tenancy clause of this nature.

In the background example, the lessee's accounting at lease commencement should ignore the possibility that the co-tenancy clause will be triggered.

Therefore, the lessee's lease liability and ROU asset at lease commencement will reflect 'lease payments' of \$5,000 (fixed payments of \$1,000 per year for five years).

If the co-tenancy clause is triggered during the lease term, we do not believe the lessee would remeasure its lease liability and ROU asset at that time. Rather, the difference between the following should be treated as negative variable lease cost:

- the lessee's actual payments (in the background example, based on 5% of the lessee's sales from the retail space); and
- the fixed payment that would apply if the co-tenancy clause had not been triggered.

Using the background example, assume the co-tenancy clause is triggered at the beginning of Year 3 and is not cured during the year. If the lessee's rent payment for the year is \$800 (\$16,000 in store sales × 5%), the lessee would incur straight-line operating lease cost of \$1,000 and *negative* variable lease cost of (\$200), for a net operating lease cost of \$800. At the beginning and end of Year 3, the lease liability would continue to be measured based on three remaining payments of \$1,000 and two remaining payments of \$1,000, respectively.

We do not believe triggering the co-tenancy clause meets any of the remeasurement requirements in paragraph 842-10-35-4, including the triggering event in paragraph 842-10-35-4(b) related to the resolution of a contingency. We do not believe the co-tenancy event resolves a contingency because inherent to that remeasurement item is that the relevant contingency is resolved for 'the remainder of the lease term'. Therefore, unless the co-tenancy event is contractually irreversible for the remainder of the lease term (i.e. the contract does not permit the lessor to cure the co-tenancy event once it is triggered), we believe paragraph 842-10-35-4(b) does not apply. [\[842-10-35-4, ASU 2016-02.BC238\]](#)

When, and after, the co-tenancy clause is triggered, the lessee should consider whether the co-tenancy event requires it to test the asset group that includes the ROU asset for the leased space for impairment (see section 6.5).



## Example 6.6.20

### Lessee accounting for a co-tenancy clause

Lessee LE signs a lease with Lessor LR to occupy a retail space in a center with four anchor tenants. The lease terms are as follows:

Lease payments:	Fixed payments of \$100,000 per year in arrears, increasing \$5,000 each year
Lease term:	5 years
Co-tenancy clause:	If an anchor tenant vacates, LE's rent will be 5% of gross sales for the lesser of 24 months or the period of anchor vacancy
Incremental borrowing rate (implicit rate is not readily determinable):	5%
Initial direct costs (LE):	\$5,000

Based on the above, and absent a co-tenancy event, LE accounts for the lease as follows:

Year	Lease liability				ROU asset			Single lease cost
	Beginning balance	Accretion	Payments	Ending balance	Beginning balance	Amort.	Ending balance	
1	\$474,132	\$23,707	(\$100,000)	\$397,839	\$479,132	\$ (87,293)	\$391,839	\$111,000
2	397,839	19,892	(105,000)	312,731	391,839	(91,108)	300,731	111,000
3	312,731	15,637	(110,000)	218,368	300,731	(95,363)	205,368	111,000
4	218,368	10,918	(115,000)	114,286	205,368	(100,082)	105,286	111,000
5	114,286	5,714	(120,000)	-	105,286	(105,286)	-	111,000

At the end of Year 1, one of the anchor tenants vacates its space and the co-tenancy clause is activated. The landlord does not find a replacement until the beginning of Year 4 of the lease. Under the co-tenancy clause, LE's rent is based on 5% of its gross sales during Years 2 and 3, which equates to \$75,000 and \$68,000, respectively.

As a result, LE records the following journal entries in Years 2 and 3:

	Year 2		Year 3	
	Debit	Credit	Debit	Credit
Lease expense	111,000		111,000	
Lease liability <sup>1</sup>		85,108		94,363
Lease expense <sup>2</sup>			30,000	42,000
ROU asset <sup>3</sup>			91,108	95,363
Cash			75,000	68,000

## Notes:

1. Original lease payment of \$105,000 and \$110,000, respectively, less accretion of \$19,892 and \$15,637, respectively.
2. Difference between the lease payments included in the measurement of the lease liability (\$105,000 and \$110,000, respectively) and the percentage rent paid under the co-tenancy clause (\$75,000 and \$68,000, respectively).
3. Straight-line single lease cost each year (\$111,000) less accretion of the lease liability (\$19,892 and \$15,637, respectively).

**Note:** While not illustrated in this example, LE should consider whether the co-tenancy event requires it to test the asset group that includes the ROU asset for the leased space for impairment.



## Question 6.6.70

### Minimum annual guarantee clauses

#### When a minimum annual payment amount becomes fixed, does that trigger a remeasurement of the lease?

**Background:** Leases often include minimum annual guarantee (MAG) clauses whereby the payments for the lease are performance- or usage-based (e.g. based on a percentage of sales), subject to a minimum amount that resets each year. For example, the lease may require payments equal to 5% of sales from a retail location, subject to a minimum guaranteed amount that resets each year based on the prior year's sales.

In some leases, the MAG amount is permitted to go up or down each year; in others, the MAG cannot decrease during the lease term once it has increased – i.e. it can only continue to increase.

**Interpretive response:** It depends on whether the MAG amount can go up or down during the lease term, or only up.

#### MAG can go up or down from the prior year when it resets

If a MAG can go up or down each year, we do not believe the annual reset of the MAG triggers any of the remeasurement requirements in paragraph 842-10-35-4.

This includes paragraph 842-10-35-4(b) related to the resolution of a contingency. We do not believe setting the MAG for any given year represents the resolution of a contingency because the reset MAG is not a fixed amount as described in paragraph 6.6.90 and Example 6.6.70 after any single year's MAG is established; it can increase or decrease each subsequent year.

Rather, despite the MAG, the variable payments the lessee will make under the lease are not substantively different from other variable lease payments based on performance or usage of the underlying asset (e.g. payments based on a percentage of retail location sales).

Therefore, as illustrated in Example 6.6.30 (Scenario 1), if only the Year 1 MAG is fixed at lease commencement, and there are no other fixed payments under

the contract, after that MAG is satisfied, the lessee will have no recognized lease liability for the remainder of the lease term absent the occurrence of another remeasurement event.

### **MAG can only go up from the prior year when it resets**

If a MAG cannot decrease during the lease term, the fixed lease payments at lease commencement equal the Year 1 MAG times the number of years in the lease term.

If the MAG increases in a subsequent year, this *does* trigger a remeasurement of the lease payments under paragraph 842-10-35-4(b). In contrast to the scenario where the MAG can go up or down with each year's reset, upon a reset that increases the MAG to a level from which it cannot subsequently decrease, some of the variable lease payments become fixed for the remainder of the lease term.

For example, if the MAG increases from \$1,000 in Year 1 to \$1,100 in Year 2, and the MAG can never again be lower than \$1,100, there are now fixed lease payments of \$1,100 (versus \$1,000) times the number of years remaining in the lease term.

Unlike in the scenario where the MAG can go up or down with each year's reset, the lessee will have a recognized lease liability throughout the lease term until the final year MAG is paid. The lessee's single lease cost and variable lease cost will also differ.

The table in paragraph 6.6.140 highlights the steps required to account for a remeasurement resulting from some of the variable lease payments to be paid over the remainder of the lease term becoming fixed.



### **Example 6.6.30** **Minimum annual guarantee (MAG) payment that resets each year**

#### **Scenario 1: MAG can go up or down from the prior year when it resets**

Lessee LE enters into a five-year lease of a 10,000 square foot retail space from Lessor LR that commences on January 1, Year 1. There are no renewal or termination options; therefore, the lease term is five years. LE classifies the lease as an operating lease, because none of the tests for classification as a finance lease are met (see paragraph 6.2.50).

The following additional facts are relevant.

Lease payments:	Annual lease payments, payable in arrears, equal to 5% of annual sales from the retail space, subject to the MAG
Minimum annual guarantee (MAG):	\$132,000 for Year 1, resets each year at an amount equal to 5% of the prior year's sales from the retail space with no restriction on that amount being less than in the prior year
Lease term:	5 years

Incremental borrowing rate (implicit rate is not readily determinable):	10%
Initial direct costs (for LE), lease incentives or lease prepayments:	None
Modifications or remeasurement events:	None
Non-lease components:	None

Additional assumptions about the amount of variable payments that are probable throughout the year are provided in the notes to the lease cost tables.

### ***Initial measurement***

The MAG for Year 1 is specified in the contract and is unavoidable. Therefore, it is a 'lease payment' and included in the measurement of the lease liability at lease commencement. Even though significant rental payments in excess of the Year 1 MAG are expected during the lease term, at lease commencement, the only 'lease payment' is the Year 1 MAG. All other payments expected to be made under the lease are variable at lease commencement and do not depend on an index or a rate.

At lease commencement, LE recognizes:

- lease liability of \$120,000. This is the present value of the Year 1 MAG of \$132,000, discounted at 10% for one year; and
- corresponding ROU asset of \$120,000, because there are no initial direct costs, lease incentives or lease prepayments.

### ***Subsequent measurement***

#### *Lease liability*

The annual reset of the MAG is *not* a remeasurement event. Consequently, in this scenario, LE will not remeasure the lease liability each year to reflect the new annual MAG.

The lease liability will be reduced to zero on payment at the end of Year 1. Because the lease is not modified or remeasured, once the Year 1 MAG payment is made, LE has no further lease liability for the remainder of the lease term.

Year	Beg. balance	Interest	Payments	End. balance
1	\$120,000	\$12,000	\$(132,000)	\$-
2	-	-	-	-
3	-	-	-	-
4	-	-	-	-
5	-	-	-	-

*ROU asset*

The amortization of the ROU asset and the carrying amount of the ROU asset at the end of each year are as follows.

Year	ROU asset amortization			ROU asset carrying amount		
	Single lease cost <sup>1</sup>	Lease liab. accret.	ROU asset amort. <sup>2</sup>	Beg. balance	ROU asset amort.	End. balance
1	\$26,400	\$(12,000)	\$14,400	\$120,000	\$(14,400)	\$105,600
2	26,400	-	26,400	105,600	(26,400)	79,200
3	26,400	-	26,400	79,200	(26,400)	52,800
4	26,400	-	26,400	52,800	(26,400)	26,400
5	26,400	-	26,400	26,400	(26,400)	-

Notes:

1. Lease payments of \$132,000 / 5 years = \$26,400.
2. Equals single lease cost – lease liability accretion.

*Lease cost*

The following table summarizes the amounts LE recognizes in profit or loss each year of the lease.

Year	Annual sales	5% of annual sales	MAG	Variable lease cost	Single lease cost <sup>1</sup>	Total lease cost
1	\$2,700,000	\$135,000	\$132,000	\$ 3,000	\$26,400	\$ 29,400
2	2,850,000	142,500	135,000	142,500	26,400	168,900
3	2,750,000	137,500	142,500	142,500	26,400	168,900
4	2,700,000	135,000	137,500	137,500	26,400	163,900
5	2,800,000	140,000	135,000	140,000	26,400	166,400

Note:

1. In Year 1, lease liability accretion ( $\$12,000 = \$120,000 \times 10\%$ ) plus ROU asset amortization (\$14,400). In Years 2–5 the single lease cost equals the ROU asset amortization of \$26,400.

The following tables further illustrate the variable lease cost that LE recognizes, by quarter, in Years 1 and 2. Consistent with paragraph 6.4.200, even though LE will make its lease payments at the end of each year, it accrues its lease cost in interim periods. Variable lease cost for the interim periods in Years 3–5 would be calculated in the same way as for Year 2.

**Year 1**

Because the Year 1 MAG payment is recognized through the single lease cost of \$26,400 per year (\$6,600 per quarter), the variable lease cost for Year 1 is solely the amount owed by LE that is greater than the MAG: \$3,000 (\$135,000 – \$132,000).

Period	YTD sales	5% of YTD sales	Cumulative min. annual pmt. <sup>1</sup>	YTD variable lease cost <sup>2</sup>	QTD variable lease cost <sup>3</sup>
Q1 Yr 1	\$ 700,000	\$ 35,000	\$ 33,000	\$1,500	\$1,500
Q2 Yr 1	1,300,000	65,000	66,000	1,500	-
Q3 Yr 1	1,950,000	97,500	99,000	1,500	-
Q4 Yr 1	2,700,000	135,000	132,000	3,000	1,500

Notes:

1. The MAG for the year, divided by four quarters, multiplied by the number of quarters elapsed in the year. In Year 1 this is the MAG of \$132,000 divided by four quarters (\$33,000), multiplied by the number of quarters elapsed (\$33,000 × 3 = \$99,000 in Q3).
2. Equals the pro rata amount probable LE will owe above the Year 1 MAG for the entire year (e.g. at the end of Q2). The following facts are relevant to how LE recognizes the \$3,000 during the quarterly periods.
  - At lease commencement, LE concludes it is not probable that it will owe LR amounts in excess of the \$132,000 Year 1 MAG.
  - Based on better than expected Q1 sales, at the end of Q1, LE concludes it is probable that it will owe \$6,000 in addition to the \$132,000 MAG (or \$138,000 total).
  - After Q2 sales that are substantially weaker than Q1, LE concludes it is no longer probable that it will owe amounts above the \$132,000 MAG. However, in accordance with paragraph 842-20-55-2, the \$1,500 accrued in Q1 is not reversed in Q2 or Q3 because it is not probable that it will *not* be owed.
  - It is not until Q4 that LE again concludes that it is probable that it will owe in excess of the \$132,000 Year 1 MAG.
3. Equals the difference between the YTD variable lease cost calculated in Note 2 and what has been recognized in prior quarters of Year 1. The corresponding credit to each of these amounts is an accrued liability for the variable lease payment that will be paid at the end of the year.

## Year 2

Period	YTD sales	5% of YTD sales	Cumulative min. annual pmt. <sup>1</sup>	YTD variable lease cost <sup>2</sup>	QTD variable lease cost <sup>3</sup>
Q1 Yr 2	\$ 650,000	\$ 32,500	\$ 33,750	\$ 33,750	\$33,750
Q2 Yr 2	1,400,000	70,000	67,500	70,000	36,250
Q3 Yr 2	2,100,000	105,000	101,250	105,000	35,000
Q4 Yr 2	2,850,000	142,500	135,000	142,500	37,500

Notes:

1. See Note 1 in the Year 1 table.
2. Equals the pro rata amount probable LE will owe for the entire year (e.g. at the end of Q2). The following facts are relevant to how LE recognizes the \$142,500 during the quarterly periods.
  - At the beginning of Year 1, LE concludes it is not probable that it will owe LR amounts in excess of the \$135,000 Year 2 MAG; LE estimates that Year 2 sales will be consistent with Year 1.

- After Q2 sales that are substantially stronger than Q1 and consideration of other factors, LE concludes it is probable that it will owe amounts above the \$135,000 MAG. LE concludes it is probable that sales in the second half of Year 2 will at least equal those in the first half of the year, which would result in LE owing \$140,000 to LR in Year 2. Consequently, as of the end of Q2, LE has recognized \$70,000 in variable lease cost ( $\$140,000 / 4 \text{ quarters} \times 2 \text{ quarters lapsed}$ ).
  - It is not until Q4's sales that LE concludes that it is probable that it will owe in excess of the \$140,000 for all of Year 2.
3. The amount necessary for the YTD variable lease cost to equal the greater of the amount calculated in Note 2. The corresponding credit to each of these amounts is an accrued liability for the variable lease payment that will be paid at the end of the year.

### **Scenario 2: MAG can only go up from the prior year when it resets**

Assume the same facts as in Scenario 1 except that the MAG for any given year cannot be less than the MAG for the prior year – i.e. it can only increase.

#### ***Initial measurement***

Because the Year 1 MAG cannot decrease in subsequent years of the lease term, the 'lease payments' equal \$660,000 (Year 1 MAG of \$132,000  $\times$  5 years) at lease commencement, and are included in the commencement date measurement of the lease liability. Payments above the annual MAG at lease commencement (\$132,000 per year) are variable lease payments that do not depend on an index or a rate; therefore, they are not included in the lease payments and do not affect the commencement date measurement of the lease liability.

At lease commencement, LE recognizes the following:

- lease liability of \$500,384. This is the present value of the five lease payments totaling \$660,000, discounted at 10%; and
- corresponding ROU asset of \$500,384 because there are no initial direct costs, lease incentives or lease prepayments.

#### ***Subsequent measurement***

An increase to the MAG triggers a remeasurement of the lease payments because, in that event, some of the previously variable lease payments to be paid over the remainder of the lease term become fixed.

The following table shows Years 1–5 sales and the resulting MAG and MAG increase for the year (from the prior year).

Year	Annual sales	5% of annual sales	MAG increase	MAG
1	\$2,700,000	\$135,000	\$ -	\$132,000
2	2,850,000	142,500	3,000	135,000
3	2,750,000	137,500	7,500	142,500
4	2,700,000	135,000	-	142,500
5	2,800,000	140,000	-	142,500

***Lease liability***

In contrast to Scenario 1, the lease liability will be reduced to zero only after the Year 5 MAG payment is made. The following table summarizes measurement of the lease liability throughout the lease term.

Year	Beg. balance	Interest <sup>1</sup>	Payments	MAG remeasurement	End. balance
1	\$500,384	\$50,038	\$(132,000)	\$ 9,510 <sup>2</sup>	\$427,932
2	427,932	42,793	(135,000)	18,651 <sup>4</sup>	354,376
3	354,376	35,438	(142,500)	-	247,314
4	247,314	24,731	(142,500)	-	129,545
5	129,545	12,955	(142,500)	-	-

Notes:

1. Beginning balance  $\times$  10%.
2. Remeasured lease liability of \$427,932 (Year 2 MAG of \$135,000  $\times$  4 years, discounted at 10%) – \$418,422 (balance of lease liability immediately before remeasurement)<sup>3</sup> = \$9,510.
3. \$418,422 = \$500,384 + \$50,038 – \$132,000
4. Remeasured lease liability of \$354,376 (Year 3 MAG of \$142,500  $\times$  3 years, discounted at 10%) – \$335,725 (balance of lease liability immediately before remeasurement)<sup>5</sup> = \$18,651.
5. \$335,725 = \$427,932 + \$42,793 – \$135,000.

LE's remeasurement entries at the end of Year 1 and Year 2, respectively, are as follows. There are no remeasurement entries in later years because the MAG cannot decrease from its Year 2 level of \$142,500.

***End of Year 1***

	Debit	Credit
ROU asset	9,510	
Lease liability		9,510
<i>To remeasure lease liability and ROU asset for Year 2 MAG increase.</i>		

***End of Year 2***

	Debit	Credit
ROU asset	18,651	
Lease liability		18,651
<i>To remeasure lease liability and ROU asset for Year 3 MAG increase.</i>		

**ROU asset**

Similarly, the carrying amount of the ROU asset will differ from that in Scenario 1. The following table summarizes the measurement of the ROU asset throughout the lease term.

Yr.	ROU asset amortization			ROU asset carrying amount			
	Single lease cost	Lease liab. accret.	ROU asset amort. <sup>1</sup>	Beg. balance	ROU asset amort.	MAG rem. <sup>2</sup>	End. balance
1	\$132,000 <sup>3</sup>	\$(50,038)	\$ 81,962	\$500,384	\$ (81,962)	\$ 9,510	\$427,932
2	135,000 <sup>4</sup>	(42,793)	92,207	427,932	(92,207)	18,651	354,376
3	142,500 <sup>5</sup>	(35,438)	107,062	354,376	(107,062)	-	247,314
4	142,500 <sup>5</sup>	(24,731)	117,769	247,314	(117,769)	-	129,545
5	142,500 <sup>5</sup>	(12,955)	129,545	129,545	(129,545)	-	-

Notes:

1. Equals single lease cost – lease liability accretion.
2. MAG remeasurement equal to the adjustment to the lease liability.
3. See Year 1 column in remaining lease cost table that follows.
4. See Year 2 column in remaining lease cost table that follows.
5. See Year 3 column in remaining lease cost table that follows.

Remaining lease cost	Year 1 <sup>3</sup>	Year 2 <sup>4</sup>	Years 3–5 <sup>5</sup>
Carrying amount of ROU asset beginning of year	\$500,384	\$427,932	\$354,376
Plus: Accretion to be recognized on the lease liability over remaining lease term <sup>6</sup>	159,616	112,068	73,124
<b>Remaining lease cost</b>	<b>\$660,000</b>	<b>\$540,000</b>	<b>\$427,500</b>
<b>Remaining lease cost per year</b>	<b>\$132,000</b>	<b>\$135,000</b>	<b>\$142,500</b>

Note:

6. Remaining unpaid lease payments – remeasured lease liability.

**Lease cost**

The following table summarizes the amounts LE recognizes in profit or loss each year of the lease.

Year	Annual sales	5% of annual sales	MAG	Variable lease cost	Single lease cost <sup>1</sup>	Total lease cost
1	\$2,700,000	\$135,000	\$132,000	\$3,000	\$132,000	\$135,000
2	2,850,000	142,500	135,000	7,500	135,000	142,500
3	2,750,000	137,500	142,500	-	142,500	142,500
4	2,700,000	135,000	142,500	-	142,500	142,500
5	2,800,000	140,000	142,500	-	142,500	142,500

## Note:

- See remaining lease cost per year in ROU asset measurement table above.

The following tables further illustrate the amounts LE recognizes in profit and loss, by quarter, during the lease term. As described in paragraph 6.4.200, even though LE will make its lease payments at the end of each year, it accrues its lease cost in interim periods based on the amount that is probable for the year.

Years 4 and 5 are not illustrated because they should, like Year 3, solely reflect quarterly recognition of the single lease cost. LE concludes that it is not probable in any of Years 3–5 that it will owe LR amounts for the year in excess of the \$142,500 MAG.

**Year 1**

Period	YTD sales	5% of YTD sales	Cumulative single lease cost <sup>1</sup>	YTD variable lease cost <sup>2</sup>	QTD variable lease cost <sup>3</sup>
Q1 Yr 1	\$ 700,000	\$ 35,000	\$ 33,000	\$1,500	\$1,500
Q2 Yr 1	1,300,000	65,000	66,000	1,500	-
Q3 Yr 1	1,950,000	97,500	99,000	1,500	-
Q4 Yr 1	2,700,000	135,000	132,000	3,000	1,500

## Notes:

- \$132,000 / 4 quarters = \$33,000.
- Equals the pro rata amount probable LE will owe above the Year 1 MAG for the entire year (e.g. at the end of Q2). The following facts are relevant to how LE recognizes the \$3,000 during the quarterly periods.
  - At lease commencement, LE concludes it is not probable that it will owe LR amounts in excess of the \$132,000 Year 1 MAG.
  - Based on better than expected Q1 sales, at the end of Q1, LE concludes it is probable that it will owe \$6,000 in addition to the \$132,000 MAG (or \$138,000 total).
  - After Q2 sales that are substantially weaker than Q1, LE concludes it is no longer probable that it will owe amounts above the \$132,000 MAG. However, in accordance with paragraph 842-20-55-2, the \$1,500 accrued in Q1 is not reversed in Q2 or Q3 because it is not probable that it will *not* be owed.
  - It is not until Q4 that LE again concludes that it is probable that it will owe in excess of the \$132,000 Year 1 MAG.
- The amount necessary for the YTD variable lease cost to equal the appropriate pro rata portion of the amount LE concludes it is probable that it will owe above the MAG at the end of the year. The corresponding credit to each of these amounts is an accrued liability for the variable lease payment that will be paid at the end of the year.

**Year 2**

Period	YTD sales	5% of YTD sales	Cumulative single lease cost <sup>1</sup>	YTD variable lease cost <sup>2</sup>	QTD variable lease cost <sup>3</sup>
Q1 Yr 2	\$ 650,000	\$ 32,500	\$ 33,750	\$ -	\$ -
Q2 Yr 2	1,400,000	70,000	67,500	2,500	2,500

Period	YTD sales	5% of YTD sales	Cumulative single lease cost <sup>1</sup>	YTD variable lease cost <sup>2</sup>	QTD variable lease cost <sup>3</sup>
Q3 Yr 2	2,100,000	105,000	101,250	3,750	1,250
Q4 Yr 2	2,850,000	142,500	135,000	7,500	3,750

Notes:

1.  $\$135,000 / 4 \text{ quarters} = \$33,750$ .
2. Equals the pro rata amount probable LE will owe for the entire year (e.g. at the end of Q2). The following facts are relevant to how LE recognizes the \$142,500 during the quarterly periods.
  - At the beginning of Year 1, LE concludes it is not probable that it will owe LR amounts in excess of the \$135,000 Year 2 MAG; LE estimates that Year 2 sales will be consistent with Year 1.
  - After Q2 sales that are substantially stronger than Q1 and consideration of other factors, LE concludes it is probable that it will owe amounts above the \$135,000 MAG. LE concludes it is probable that sales in the second half of Year 2 will at least equal those in the first half of the year, which would result in LE owing \$140,000 to LR in Year 2. Consequently, as of the end of Q2, LE has recognized \$2,500 in variable lease cost ( $(\$140,000 - \$135,000) / 4 \text{ quarters} \times 2 \text{ quarters lapsed}$ ).
  - It is not until Q4's sales that LE concludes that it is probable that it will owe in excess of the \$140,000 for all of Year 2.
3. The amount necessary for the YTD variable lease cost to equal the appropriate pro rata portion of the amount LE concludes it is probable that it will owe above the MAG at the end of the year. The corresponding credit to each of these amounts is an accrued liability for the variable lease payment that will be paid at the end of the year.

### Year 3

Period	YTD sales	5% of YTD sales	Cumulative single lease cost <sup>1</sup>	YTD variable lease cost <sup>2</sup>	QTD variable lease cost <sup>3</sup>
Q1 Yr 3	\$ 650,000	\$ 32,500	\$ 35,625	\$-	\$-
Q2 Yr 3	1,300,000	65,000	71,250	-	-
Q3 Yr 3	2,000,000	100,000	106,875	-	-
Q4 Yr 3	2,750,000	137,500	142,500	-	-

Notes:

1.  $\$142,500 / 4 \text{ quarters} = \$35,625$ .
2. Equals the pro rata amount probable LE will owe for the entire year (e.g. at the end of Q2). In Year 3, LE never concludes it is probable that it will owe an amount above the Year 3 MAG.
3. The amount necessary for the YTD variable lease cost to equal the appropriate pro rata portion of the amount LE concludes it is probable that it will owe above the MAG at the end of the year. The corresponding credit to each of these amounts is an accrued liability for the variable lease payment that will be paid at the end of the year.



## Question 6.6.80

### Contingent lease incentives

#### Should a lessee remeasure the lease for a lease incentive that is paid or becomes payable to the lessee after the commencement date upon the resolution of a contingency?

**Background:** Lessors will often offer lease incentives that are contingent on future events or lessee actions. For example, lessors will often offer to reimburse lessees for all or a portion of the cost of leasehold improvements. To receive the reimbursement, the lessee must construct or install the leasehold improvements and provide evidence of the costs incurred. This may result in a one-time incentive that occurs at a specified point in time after lease commencement or may involve multiple payments made during the lease term when the lessee incurs incremental leasehold improvement costs – e.g. a payment to the lessee or a reduction of rent each year that the lessee incurs leasehold improvement costs above a specified amount.

**Interpretive response:** It depends. Because Topic 842 does not specifically address how a lessee should account for contingent lease incentives that are not paid or payable at lease commencement, we believe there may be more than one acceptable approach to accounting for a contingent lease incentive.

#### Change in lease payments

We believe one acceptable approach is to account for any lease incentive that becomes paid or payable to the lessee after the commencement date as a change (i.e. a reduction) in the lease payments. Under this approach, the resolution of the contingency that reduces the lease payments – whether the incentive is or will be paid to the lessee, or realized through a reduction in future payments from the lessee to the lessor – is accounted for in the same manner as any other change in the lease payments resulting from the resolution of a contingency. Accordingly, the lessee would follow the guidance that requires it to remeasure the lease liability to reflect a change in the lease payments.

[842-20-35-4]

As described in paragraph 6.6.170 and illustrated in Example 6.6.70, this means that the change in the lease liability will be accounted for prospectively as an adjustment to the carrying amount of the ROU asset – i.e. unless the amount of the remeasurement would reduce the carrying amount of the ROU asset to an amount less than zero.

#### Estimation at lease commencement

We believe another approach is also acceptable if the occurrence of the future event(s) on which the lease incentive is contingent is (1) probable and (2) within the lessee's control – e.g. the lessee is constructing leasehold improvements.

When both those conditions are met at lease commencement, we believe it is acceptable for the lessee to estimate the lease incentives to which it is probable to be entitled at lease commencement and include such amounts in the lease payments. In that case, the lessee actually becoming entitled to receive those incentives (e.g. when the probable event within the control of the

lessee occurs) does not result in a change to the lease payments, and therefore does not require remeasurement of the lease. However, if the estimated lease incentives are not received (e.g. because the lessee ultimately does not become entitled to receive them), or the lessee becomes entitled to receive additional incentives that were not previously estimated, that would be accounted for as a change in the lease payments (i.e. consistent with the first approach).

### Other approaches

Other approaches also may be acceptable depending on the facts and circumstances.

We believe the approach selected by a lessee or lessor is an accounting policy choice that should be applied consistently to similar facts and circumstances.



### Question 6.6.90

#### Contingent lease incentives (receivable) that exceed the carrying amount of the ROU asset (lease liability)

### How should a lessee account for contingent lease incentives (receivable) that exceed the carrying amount of the ROU asset (lease liability)?

**Background:** Guidance in section 6.3 discusses the accounting when:

- unpaid lease incentives receivable would reduce the carrying amount of the lease liability below zero (Question 6.3.14); and
- the amount to be recorded for a lease incentive exceeds the carrying amount of the ROU asset (Question 6.3.15).

**Interpretive response:** See Questions 6.3.14 and 6.3.15. We believe the guidance in those questions applies equally to contingent lease incentives, which may be recorded before they are received or become receivable from the lessor if the lessee has elected the 'estimation at lease commencement' approach (see Question 6.6.80).



### Question 6.6.100

#### Variable lease payment 'holidays'

### How should a lessee account for a variable lease payment 'holiday' in an operating lease?

**Background:** In some operating leases where the rental payments are entirely variable (e.g. based on a percentage of sales in the case of a retail or restaurant outlet), as an incentive to enter into the lease, the lessor waives the variable rent payments either (1) for a specified period of time – e.g. first three months

of the lease or (2) up to a specified amount – e.g. on the first \$1,000,000 in sales to which the variable rent provision would otherwise apply.

The question arises as to whether the ‘free rent’ should be treated as a lease incentive and recognized as a reduction to operating lease cost (consistent with Question 6.6.90), or instead should result in no rent expense being recognized during the free rent period or until the waived amount is exceeded.

**Interpretive response:** We believe in lease scenarios like those described in the background, Topic 842 supports two approaches, either of which we will accept if applied consistently to similar circumstances. Example 6.6.40 illustrates both approaches.

#### **Approach 1: Recognize waived rent as an incentive over the lease term**

Under this approach, variable lease cost is theoretically incurred (i.e. recognized) and simultaneously waived, with the waived amount being recognized as a lease incentive. The lease is remeasured at that time as the variable incentive (i.e. variable negative lease payment) becomes fixed – i.e. as the contingency around the incentive is resolved.

In some cases, the incentive is earned based on actions outside of the control of the lessee – e.g. third-party customers making purchases (illustrated in Example 6.6.40). In such cases, the lessee is not permitted to apply the ‘estimation at lease commencement’ approach to the waived rent incentive even if it is probable it will earn the full amount (see Question 6.6.80).

#### **Approach 2: Recognize variable lease cost only once the free rent is exhausted**

Under this approach, variable lease cost is not recognized until the obligation for those payments is incurred. Therefore, no variable lease cost is recognized until the incentive is fully used and the lessee has an obligation to make variable lease payments. [842-20-25-6(b)]

In the free rent *period* scenario described in the background, there is no obligation to make variable lease payments during the excluded lease periods.

Similarly, in the waived rent *amount* scenario in the background, there is no obligation to make variable lease payments until the specified threshold (e.g. store sales) has been exceeded. Although it is probable that the lessee will ultimately exceed the specified threshold and therefore be required to make variable lease payments, the guidance in paragraph 6.4.200 to accrue amounts before exceeding the threshold does not apply. This is because the variable lease payments to be made after exceeding the threshold are based solely on sales *above* that threshold – i.e. no payments are owed from reaching the exempt sales threshold.

#### **Comparing the two approaches**

Approach 2 is simpler to apply because it does not require remeasurement(s) of the lease, and does not require ongoing accounting post-removal for a lease incentive. However, Approach 1 achieves a more equal distribution of lease expense over the lease term; rather than recognizing the effect of the free (or waived) rent entirely at the beginning of the lease term, it recognizes the effect over the entire lease term.



## Example 6.6.40

### Variable lease payment holiday

Lessee LE enters into a five-year restaurant space lease with Lessor LR, under which LE is entitled to free variable rent on its first \$1,000,000 in sales in the restaurant. There are no non-lease components of the contract and no other lease incentives provided.

#### Scenario 1: Waived rent recognized as incentive over lease term

In **Month 1**, sales are \$450,000 so that the waived rent equals \$22,500:  $\$450,000 \times 5\%$ . LE remeasures the lease to account for this now-fixed lease incentive, either reducing the ROU asset or creating a lease incentive liability (see Question 6.6.90) for the portion that does not relate to Month 1.

- LE recognizes Month 1 lease expense of \$22,125:  $\$22,500 - \$375 (\$22,500 / 60 \text{ months})$ .
- At the end of Month 1, the corresponding amount is unamortized lease incentive: \$22,125.

In **Month 2**, sales are \$550,000 so that waived rent is \$27,500:  $\$550,000 \times 5\%$ . LE again remeasures the lease to account for this waived rent as a fixed lease incentive.

- LE recognizes Month 2 lease expense of \$26,659: waived rent (\$27,500) net of incentive amortization (\$841):  $\$375 (\$22,500 / 60 \text{ months}) + \$466 (\$27,500 / 59 \text{ months})$ .
- At the end of Month 2, the unamortized waived rent lease incentive is \$48,784:  $(\$22,500 - [\$375 \times 2 \text{ months}]) + (\$27,500 - [\$466 \times 1 \text{ month}])$ .

Beginning with **Month 3** and for the remainder of the lease, monthly lease expense equals the variable amount incurred, less monthly amortization of the waived rent lease incentive of \$841 ( $\$375 + \$466$ ).

#### Scenario 2: Waived lease cost recognized once free rent exhausted

In Month 1 and Month 2, LE recognizes no lease expense and does not remeasure the lease for the waived variable rent.

Beginning with Month 3 and for the remainder of the lease, monthly lease expense equals the variable amount incurred. At no time during the lease term under this approach does LE recognize a lease incentive.

## 6.6.2 Accounting for a change arising from a reassessment



### Excerpt from ASC 842-20

#### 35 Subsequent Measurement

##### General

> Remeasurement of the Lease Liability

**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)).

**35-6** See Examples 3 and 4 (paragraphs 842-20-55-21 through 55-46) for an illustration of the requirements on lessee subsequent measurement.

## 55 Implementation Guidance and Illustrations

### General

> Implementation Guidance

• > Illustrations of Lessee Recognition, Measurement, and Reassessment of the Lease Term

55-21 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.

• • > Example 3—Initial and Subsequent Measurement by a Lessee and Accounting for a Change in the Lease Term

• • • > Case A—Initial and Subsequent Measurement of the Right-of-Use Asset and the Lease Liability

**55-22** Lessee enters into a 10-year lease of an asset, with an option to extend for an additional 5 years. Lease payments are \$50,000 per year during the initial term and \$55,000 per year during the optional period, all payable at the beginning of each year. Lessee incurs initial direct costs of \$15,000.

**55-23** At the commencement date, Lessee concludes that it is not reasonably certain to exercise the option to extend the lease and, therefore, determines the lease term to be 10 years.

**55-24** The rate implicit in the lease is not readily determinable. Lessee's incremental borrowing rate is 5.87 percent, which reflects the fixed rate at which Lessee could borrow a similar amount in the same currency, for the

same term, and with similar collateral as in the lease at the commencement date.

**55-25** At the commencement date, Lessee makes the lease payment for the first year, incurs initial direct costs, and measures the lease liability at the present value of the remaining 9 payments of \$50,000, discounted at the rate of 5.87 percent, which is \$342,017. Lessee also measures a right-of-use asset of \$407,017 (the initial measurement of the lease liability plus the initial direct costs and the lease payment for the first year).

**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 ( $\$407,017 \div 10$ ) and the interest expense of \$20,076 ( $5.87\% \times \$342,017$ ).

**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 ( $\$515,000 \div 10$  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.

**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 ( $\$334,023 \div 9$ ) and interest expense of \$23,896 ( $7.83\% \times \$305,189$ ).

• • • > 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).

6.6.120 The discussion, diagram and chart that follows complement the overview diagram in paragraph 6.6.10, and deal with remeasurements resulting from lease reassessments. Lease modifications are discussed in section 6.7.

6.6.130 The accounting steps a lessee must undertake depend on which of the following circumstances requires the lessee to undertake the remeasurement.  
[842-10-25-1, 35-4, 842-20-35-4 – 35-5]



6.6.140 The following diagram summarizes the accounting steps a lessee must undertake in each of the above circumstances.

Accounting steps	Circumstance			
	1	2	3	4
Remeasure and reallocate the ‘consideration in the contract’ to the remaining lease and non-lease components of the contract (see chapter 4). <sup>3</sup>	✓	✓	✓	✓
Remeasure the lease liability to reflect the revised lease payments, using a ‘discount rate for the lease’ (see section 5.6) determined at the remeasurement date. <sup>1,2</sup>	✓	✓	✗	✗
Remeasure the lease liability to reflect the revised lease payments, using the discount rate for the lease in effect immediately before the remeasurement. <sup>1</sup>	✗	✗	✓	✓
Adjust the amount of the ROU asset by the amount of the remeasurement of the lease liability. However, once the ROU asset is reduced to zero, then the remaining amount of the lease liability remeasurement is recognized in the income statement.	✓	✓	✓	✓
Reassess lease classification (see section 6.2) at the remeasurement date based on the circumstances at the remeasurement date (e.g. fair value and remaining economic life of the underlying asset at the remeasurement date).	✓	✓	✗	✗
If there is a change in lease classification (see section 6.2), adjust the remaining lease cost recognition pattern and presentation in the income statement and statement of cash flows prospectively.	✓	✓	✗	✗

Notes: [842-10-35-5, ASU 2016-02.BC237]

1. When a lessee remeasures the lease payments, variable lease payments that depend on an index or rate are measured using the index or rate as of the remeasurement date.
2. The discount rate is not updated for circumstances #1 or #2 if the discount rate for the lease already reflects that the lessee has an option to extend or terminate the lease or to purchase the underlying asset.
3. See Question 6.6.110.

6.6.150 After the commencement date, a lessee remeasures the lease liability to reflect the changes to the lease payments. The lease liability is remeasured using an updated discount rate only if the remeasurement is due to a change in the lease term or a change in the lessee's assessment of whether it will exercise an option to purchase the underlying asset. If the lease liability is remeasured for another reason, the discount rate is not updated. [842-20-35-4 – 35-5]



### Observation

#### **Discount rate not updated in all cases**

6.6.160 The Board decided that, in general, an entity should not reassess the discount rate used to measure the lease liability during the lease term because that is generally consistent with the amortized cost accounting for other, similar financial liabilities. However, the Board concluded that a change in the lease term or in the assessment of a lessee purchase option represents a significant change in the economics of the arrangement, and therefore the discount rate for the lease should be adjusted in those cases. [ASU 2016-02.BC240–BC242]

6.6.170 A lessee recognizes as an adjustment to the ROU asset the amount of remeasurement of the lease liability, unless the carrying amount of the ROU asset is reduced to zero (in which case any remaining amount of the remeasurement is recognized in net income). This means that, unless the carrying amount of the ROU asset is reduced to zero, the effect of the remeasurement in the income statement is prospective. [842-20-35-4]

6.6.180 Changes to the carrying amount of the ROU asset as a result of revised assessments of the lease term or lessee purchase options also require the lessee to revise useful life estimates for the ROU asset (and related assets, such as leasehold improvements) and amortization expense on a prospective basis.



### Observation

#### **Changes to the lease liability generally recognized as an adjustment to the ROU asset**

6.6.190 Changes in the lease term or lease payments related to a purchase option represent a lessee's expectation that it has acquired more or less of the right to use the underlying asset, and an adjustment to the ROU asset should be made to appropriately measure the total cost of the revised right of use (i.e. the asset controlled by the lessee). Meanwhile, changes in estimates of the

amount probable of being owed under a residual value guarantee and changes to the lease payments resulting from the resolution of a contingency reflect changes to the cost of the existing ROU asset. [IASU 2016-02.BC232, BC238-BC239]



### Question 6.6.110

#### Stand-alone prices to use in remeasurement scenarios

### Does a lessee use stand-alone prices as of the remeasurement date when remeasuring and reallocating the consideration in the contract?

**Background:** Topic 842 requires the lessee to remeasure and reallocate the consideration in the contract to the remaining lease and non-lease components of the contract whenever a reassessment results in remeasurement of the lease. However, some have asserted Topic 842 does not specify whether the lessee does so on the basis of updated (i.e. remeasurement date) stand-alone prices.

**Interpretive response:** We believe either of the following approaches is acceptable if applied consistently:

#### Approach 1: Always use updated stand-alone prices

Use updated stand-alone prices for the lease and non-lease components, determined as of the remeasurement date, when remeasuring a lease and reallocating the consideration in the contract to those components as a result of a reassessment.

#### Approach 2: Decide based on remeasurement type

Whether to update the stand-alone prices for the lease and non-lease components used to reallocate the remeasured consideration in the contract depends on the type of remeasurement. Under this approach:

- **Type A remeasurements.** The lessee should use updated stand-alone prices (i.e. those as of the remeasurement date) when the remeasurement is a result of either a change in:
  - the lease term; or
  - the assessment of whether a lessee is reasonably certain to exercise an option to purchase the underlying asset.
- **Type B remeasurements.** The lessee should *not* use updated stand-alone prices if the remeasurement is solely the result of either (1) a change in the amount probable of being owed under a residual value guarantee, or (2) resolution of a contingency that results in variable lease payments becoming fixed.

Topic 842 differentiates between Type A and Type B remeasurements; the former are intended to create a 'fresh look' at the lease based on changed economics, and the latter are intended to merely update a judgment or estimate. For example, in the event of a Type A remeasurement, the lessee

revises its discount rate for the lease and reassesses the lease classification, but does neither of those in the event of a Type B remeasurement.

We believe the underlying concept that Type A remeasurements reflect a fresh look at the lease extends to the stand-alone prices used to reallocate the remeasured consideration in the contract. We believe it would be inconsistent with that logic to continue to use historical stand-alone prices. Conversely, the Board's treatment of Type B remeasurements as changes in a judgment or estimate that do not in effect create a new lease provides support for not revisiting the stand-alone prices of the components.



### Question 6.6.115

#### Termination penalties added to lease payments from lease term reassessment

#### Should all or a portion of a termination penalty added to the lease payments because of a lease term reassessment be recognized in profit or loss at the remeasurement date?

**Background:** A termination penalty called for by a lease contract is not included in the 'lease payments' if the lessee is reasonably certain not to exercise the termination option that would trigger the penalty (see section 5.4.5).

If the lessee reassesses, and changes, the lease term so that it no longer includes periods after an optional termination date, any termination penalty associated with terminating the lease at that date becomes part of the lease payments for the lease.

Had the termination payment been included in the lease payments from commencement, the lessee's lease cost each period to the remeasurement date would have been greater than what was recognized. Recognizing the cost of the termination payment over only the shortened revised lease term may result in recognizing lease cost during each of the remaining lease periods that is:

- greater than what was recognized each period pre-reassessment; and/or
- above market rental rates.

Because of this, the question arises as to whether it is appropriate to recognize all or a portion of the expected termination payment at the time the lease is remeasured for the lease term change. This would allocate a portion of the termination payment to the period(s) of the lease that have already passed as of the remeasurement date.

**Interpretive response:** No. The profit or loss effect of the termination penalty is taken through lease cost over the remainder of the lease term. Although the effects described in the background – principally, inflated lease cost over the remaining lease term – might be viewed as uneconomical, the remeasurement model in Topic 842 that applies to changes resulting from a reassessment is prospective.

As outlined in paragraph 6.6.140, changes in the lease liability resulting from changes to the lease payments (which include changes to estimated

termination payments) are recognized with a corresponding and equal adjustment to the ROU asset. Profit or loss is recognized *only* at the remeasurement date to the extent that the net ROU asset adjustment would reduce the carrying amount of the ROU asset below zero. The addition of the termination penalty to the lease payments, which increases the lease liability (and therefore, also the ROU asset) will *reduce* any net amount recognized to profit or loss from the overall remeasurement. [842-20-35-4]



### Example 6.6.50

#### Change in assessment of the lease term

Assume the same facts as in Examples 6.3.10 and 6.4.20, in which Lessee LE leases office space from Lessor LR.

At the end of Year 6, LE constructs leasehold improvements that are expected to have significant economic value at the end of the 10-year lease term, such that it becomes reasonably certain that LE will exercise the five-year extension option. Lease payments during the original and the revised lease term are as follows.

#### Non-cancellable lease period

Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8	Yr 9	Yr 10	Total
\$14,527	\$14,963	\$15,412	\$15,874	\$16,350	\$16,841	\$17,346	\$17,866	\$18,402	\$18,954	\$166,535

#### Extension period

Yr 11	Yr 12	Yr 13	Yr 14	Yr 15	Total
\$19,523	\$20,109	\$20,712	\$21,333	\$21,973	\$103,650

#### Remeasuring the lease liability and ROU asset

Because the remeasurement of the lease payments results from a change in the assessment of the lease term, LE is required to use a discount rate for the lease determined at the remeasurement date (i.e. at the end of Year 6). The rate implicit in the lease is not readily determinable. Accordingly, LE uses its incremental borrowing rate at the end of Year 6 (12%) as the discount rate for the remeasured lease, taking into account:

- a remaining lease term of nine years (four years remaining from the original lease term plus the five-year extension period); and
- the remeasured lease payments for the revised lease term of nine years.

At the end of Year 6, the carrying amounts of the lease liability and ROU asset immediately before remeasurement are \$57,306 and \$53,350, respectively (see Example 6.4.20).

LE remeasures the lease liability at the present value of the remaining lease payments for the revised lease term (i.e. Years 7–15), discounted at 12%, which is \$102,048 (or an increase of \$44,742). LE records the following journal entry.

	Debit	Credit
ROU asset	44,742	
Lease liability		44,742
<i>To remeasure ROU asset and lease liability following reassessment of lease term.</i>		

After this journal entry, the carrying amount of LE's ROU asset is \$98,092 (\$53,350 + \$44,742).

### Lease classification reassessment

LE is required to reassess the original classification of the lease as an operating lease (see Example 6.4.20). The fair value of the office space has increased since lease commencement to \$420,000, while the remaining economic life of the building in which the office space resides is 29 years. Therefore, the reassessed lease is an operating lease.

### Accounting subsequent to remeasurement

LE calculates the remaining lease cost for the lease as follows.

Total lease payments (including those paid and those not yet paid), reflecting the adjustment resulting from the lease term reassessment – i.e. all lease payments in Years 1–15	\$270,186
Plus: Total initial direct costs	5,000
Less: Periodic lease cost recognized in prior periods (straight-line lease cost of $\$17,154 \times 6$ years before remeasurement)	(102,924)
<b>Remaining cost of the lease</b>	<b>\$172,262</b>

LE recognizes a single lease cost, calculated so that the remaining cost of the lease is allocated over the remaining lease term on a straight-line basis – i.e. \$19,140 per year for the remaining nine years.

LE accounts for the lease liability and the ROU asset after the remeasurement using the guidance in Topic 842 for an operating lease, as illustrated below (using Method 2 to subsequently measure the ROU asset – see paragraph 6.4.170).

Year	ROU asset amortization			ROU asset carrying amount			Lease liab. balance
	Straight-line lease cost	Lease liab. accret.	ROU asset amort.	Beg. balance	ROU asset amort.	End. balance	
7	\$19,140	\$(12,246)	\$ 6,894	\$98,092	\$ (6,894)	\$91,198	\$96,948
8	19,140	(11,634)	7,506	91,198	(7,506)	83,692	90,716
9	19,140	(10,886)	8,254	83,692	(8,254)	75,438	83,200
10	19,140	(9,984)	9,156	75,438	(9,156)	66,282	74,230
11	19,140	(8,908)	10,232	66,282	(10,232)	56,050	63,615
12	19,140	(7,634)	11,506	56,050	(11,506)	44,544	51,140

Year	ROU asset amortization			ROU asset carrying amount			Lease liab. balance
	Straight-line lease cost	Lease liab. accret.	ROU asset amort.	Beg. balance	ROU asset amort.	End. balance	
13	19,140	(6,137)	13,003	44,544	(13,003)	31,541	36,565
14	19,141	(4,388)	14,753	31,541	(14,753)	16,788	19,620
15	19,141	(2,353)	16,788	16,788	(16,788)	-	-



## Question 6.6.120

**Impaired operating lease ROU asset amortization post-remeasurement**

**Should a lessee continue to amortize an impaired operating lease ROU asset on a straight-line basis if it is remeasured after the impairment?**

**Background:** Paragraphs 6.5.40 and 6.5.50 outline that after an operating lease ROU asset is impaired: [IAS 16-20-25-7, 35-10]

- the ROU asset is generally amortized on a straight-line basis from the impairment date; and
- the single lease cost for the operating lease will be front-loaded, calculated as the sum of the straight-line ROU asset amortization and the effective interest method accretion of the lease liability.

After it has been impaired, an operating lease ROU asset might be remeasured – e.g. because of a change in the lease term, the assessment of a lessee purchase option or the lease payments. In this case, a question arises about whether the requirement to amortize the ROU asset on a straight-line basis, and therefore the requirement to recognize a front-loaded single lease cost, continues after the remeasurement.

**Interpretive response:** Yes. We believe the ROU asset should continue to be amortized on a straight-line basis. The subsequent measurement guidance for impaired operating lease ROU assets outlined in the background does not include a provision for a return to pre-impairment accounting.

Additionally, in requiring straight-line amortization post-impairment, the FASB concluded that after the ROU asset is impaired, “the link that many perceive between the economic benefits to be derived from the lease and the lease payments, and reference in support of a single, generally straight-line lease cost for operating leases, is effectively ‘broken’ after the right-of-use asset is impaired because the lessee will no longer obtain future economic benefits from the lease equal to (or greater than) the payments it is required to make to the lessor. In other words, the lease payments no longer have any direct correlation to the economic benefits the lessee is able to derive from the lease but, instead, represent a liability reflective of a past expectation of economic benefits that could be derived from the lease.” [IAS 16-20-25-7, 35-10]

After a remeasurement, the 'link' referred to by the FASB is not re-established. The carrying amount of the ROU asset, which reflects the economic benefits to be derived from the lease, will remain uncorrelated to the lease payments.

Example 6.6.60 illustrates a lessee's accounting for an operating lease that is remeasured after an ROU asset impairment.



## Example 6.6.60

### Lease remeasurement post-impairment

Assume the same facts as in Examples 6.3.10 and 6.5.20, in which Lessee LE leases office space from Lessor LR and incurs an impairment charge in Year 2 of the lease.

At the end of Year 6, a lease term reassessment triggering event occurs. On reassessment, LE concludes it is reasonably certain to exercise the available five-year extension option.

Lease payments during the original and the revised lease term are as follows.

#### Original 10-year lease term

Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8	Yr 9	Yr 10	Total
\$14,527	\$14,963	\$15,412	\$15,874	\$16,350	\$16,841	\$17,346	\$17,866	\$18,402	\$18,954	\$166,535

#### Extension period

Yr 11	Yr 12	Yr 13	Yr 14	Yr 15	Total
\$19,523	\$20,109	\$20,712	\$21,333	\$21,973	\$103,650

#### Accounting before remeasurement

Because of the impairment in Year 2, the ROU asset carrying amount was reduced by \$10,000. After the impairment, LE began amortizing the ROU asset on a straight-line basis over the remaining original lease term. The following table reflects LE's accounting for the lease through the end of Year 6 (which is the same LE accounting through Year 6 as in Example 6.5.20).

Yr.	ROU asset carrying amount				Lease liability	Income statement <sup>2</sup>				
	Beg. balance	ROU asset amort.	Impair. charge	End. balance		Carry. amt. (end. balance) <sup>1</sup>	Accret.	ROU asset amort.	Single lease cost	Impair. charge
1	\$105,000	\$ (7,154)	\$ -	\$97,846	\$95,473	\$10,000	\$ 7,154	\$17,154	\$ -	-
2	97,846	(7,607)	(10,000)	80,239	90,057	9,547	7,607	17,154	10,000	-
3	80,239	(10,030)	-	70,209	83,651	9,006	10,030	19,036	-	-
4	70,209	(10,030)	-	60,179	76,142	8,365	10,030	18,395	-	-
5	60,179	(10,030)	-	50,149	67,406	7,614	10,030	17,644	-	-
6	50,149	(10,030)	-	40,119	57,306	6,741	10,030	16,771	-	-

At the end of Year 6, the carrying amounts of the lease liability and ROU asset are \$57,306 and \$40,119, respectively.

### Accounting for the remeasurement

Because the remeasurement of the lease payments results from a change in the assessment of the lease term, LE is required to use a discount rate for the lease determined at the remeasurement date (i.e. at the end of Year 6).

The rate implicit in the lease is not readily determinable. Accordingly, LE uses its incremental borrowing rate at the end of Year 6 (12%), taking into account:

- a remaining lease term of nine years (four years remaining from the original lease term plus the five-year extension period); and
- the remeasured lease payments for the revised lease term of nine years.

LE remeasures the lease liability at the present value of the remaining lease payments for the revised lease term (i.e. Years 7–15), discounted at 12%, which is \$102,048 (or an increase of \$44,742). LE records the following journal entry.

	Debit	Credit
ROU asset	44,742	
Lease liability		44,742
<i>To remeasure ROU asset and lease liability following reassessment of lease term.</i>		

After this journal entry, the carrying amount of LE's ROU asset is \$84,861 (\$40,119 + \$44,742).

### Accounting post-remeasurement

LE continues to amortize the ROU asset on a straight-line basis, consistent with how it was being amortized before the remeasurement.

Post-remeasurement ROU asset straight-line amortization is calculated as follows.

ROU asset carrying amount pre-remeasurement	\$40,119
Increase to ROU asset from remeasurement	44,742
<b>Remeasured ROU asset balance</b>	<b>\$84,861</b>
Remaining years in lease term	9
Annual straight-line amortization	\$(9,429)

The ROU asset will be amortized at \$9,429 per year for the remaining 9-year lease term.

The following table shows the accounting for the lease after the remeasurement.

Year	ROU asset carrying amount				Lease liability	Income statement		
	Beg. balance	ROU asset amort.	Impair. charge	End. balance	Carry. amt. (end. balance)	Accret.	ROU asset amort.	Single lease cost
7	\$84,861	\$(9,429)	\$ -	\$75,432	\$96,948	\$12,246	\$9,429	\$21,675
8	75,432	(9,429)	-	66,003	90,716	11,634	9,429	21,063
9	66,003	(9,429)	-	56,574	83,200	10,886	9,429	20,315
10	56,574	(9,429)	-	47,145	74,230	9,984	9,429	19,413
11	47,145	(9,429)	-	37,716	63,615	8,908	9,429	18,337
12	37,716	(9,429)	-	28,287	51,139	7,635	9,429	17,064
13	28,287	(9,429)	-	18,858	36,564	6,137	9,429	15,566
14	18,858	(9,429)	-	9,429	19,619	4,388	9,429	13,817
15	9,429	(9,429)	-	-	-	2,352	9,429	11,781



### Example 6.6.70

#### Resolution of contingency on which payments are based

Lessee LE leases long-lived equipment (operating lease) to be used in its production process for a lease term of five years. The following facts are relevant at lease commencement.

Lease payments:	Fixed payments of \$1,000 per year (in arrears) plus \$2 each hour that the equipment is used
Renewal/termination/purchase options:	None
Transfer of ownership:	No
LE's incremental borrowing rate:	5% (implicit rate cannot be readily determined)
Initial direct costs:	None
Lease incentives:	None

In addition, the lease contains a clause specifying that the payments will become fixed at \$2,500 per year for the remainder of the contract if the equipment is used more than 600 hours in Year 1.

At lease commencement, LE determines that the total cost for the lease is \$5,000 (\$1,000 × 5 payments). The variable payments that will be made by LE are variable lease payments. LE measures the lease liability based on the present value of the lease payments, discounted at 5%, which is \$4,329. Because there are no initial direct costs or lease incentives, the initial measurement of the ROU asset is equal to the initial measurement of the lease liability, \$4,329.

LE uses the equipment for 675 hours during Year 1. Accordingly, LE's straight-line operating lease cost is \$1,000, but LE also incurs variable lease cost of \$1,350 ( $\$2 \times 675$  hours). The carrying amount of the lease liability and the ROU asset at the end of Year 1 is \$3,545.

Because Year 1 usage of the equipment exceeded 600 hours, the payments contingent on use of the equipment become fixed at \$1,500 for the remaining lease term. Accordingly, LE remeasures the lease liability, considering four remaining lease payments of \$2,500 (\$1,000 original fixed annual payment + \$1,500 additional amount that becomes fixed for the remaining four years of the lease upon resolution of the contingency), discounted at 5%, which results in a revised lease liability balance of \$8,865 (an increase of \$5,320).

LE does not update the discount rate for the lease in remeasuring the lease liability because the remeasurement relates to the resolution of a contingency on which payments for use of the equipment were based.

LE records the following journal entry at the end of Year 1.

	<i>Debit</i>	<i>Credit</i>
ROU asset	5,320	
Lease liability		5,320
<i>To remeasure ROU asset and lease liability following resolution of contingency.</i>		

LE does not reassess lease classification because the remeasurement is not the result of a change in the assessment of the lease term, a change in the assessment of a lessee purchase option or a lease modification.

LE calculates the remaining cost of the lease as follows.

Total lease payments (including those paid and those not yet paid), reflecting the adjustment resulting from resolution of the contingency – i.e. \$1,000 for Year 1 and \$2,500 thereafter	\$11,000
Plus: Total initial direct costs attributable to the lease	-
Less: Periodic lease cost recognized in prior periods	(1,000)
<b>Remaining lease cost</b>	<b>\$10,000</b>

LE will recognize a single lease cost, calculated so that the remaining lease cost is allocated over the remaining lease term on a straight-line basis – i.e. \$2,500 per year for each of the remaining four years.

LE will account for the lease liability and ROU asset from the effective date of the remeasurement using the guidance in Topic 842 for an operating lease, as illustrated below.

Year	ROU asset amortization			ROU asset carrying amount			Lease liab. balance
	Straight-line lease cost	Lease liab. accret.	ROU asset amort.	Beg. balance	ROU asset amort.	End. balance	
2	\$2,500	\$(443)	\$2,057	\$8,865	\$(2,057)	\$6,808	\$6,808
3	2,500	(340)	2,160	6,808	(2,160)	4,648	4,648
4	2,500	(232)	2,268	4,648	(2,268)	2,380	2,380
5	2,500	(120)	2,380	2,380	(2,380)	-	-



### Example 6.6.80

#### Variable lease payments indexed to CPI

Lessee LE enters into a lease of a building for a five-year term with a two-year extension option. At lease commencement, LE does not consider exercise of the extension option to be reasonably certain.

LE's base payment under the lease is \$100,000 per year (paid in arrears). The base payment will be adjusted each year by the change in CPI after the lease commencement date. The CPI index value at lease commencement is 196.800. LE incurs no initial direct costs to enter into the lease, does not prepay any lease payments and does not receive any lease incentives.

LE cannot readily determine the rate implicit in the lease. Therefore, LE's incremental borrowing rate, which is 6% at lease commencement, is the discount rate for the lease.

The lease is classified as an operating lease. LE initially measures the lease liability as the present value of \$100,000 per year for five years, discounted at 6%. The \$100,000 initial payment already reflects the CPI index at the lease commencement date.

#### Scenario 1: Lease is not modified and lease liability is not remeasured

The following chart summarizes LE's accounting for the lease assuming that there is no remeasurement of the lease liability and no lease modification. The chart assumes that the actual outcomes during the lease term (CPI index) are known by LE at lease commencement.

Year	Single lease cost						Variable lease cost	Total lease cost		
	Base pmts.	CPI index	Actual pmts.	End. ROU asset	End. lease liab.	ROU asset amort.	Lease liab. accret.	Single lease cost		
0	\$ -	196.800	\$ -	\$421,236	\$421,236	\$ -	\$ -	\$ -	\$ -	\$ -
1	100,000	201.800	102,541	346,510	346,510	74,726	25,274	100,000	2,541	102,541
2	100,000	210.036	106,726	267,301	267,301	79,209	20,791	100,000	6,726	106,726
3	100,000	210.228	106,823	183,339	183,339	83,962	16,038	100,000	6,823	106,823
4	100,000	215.949	109,730	94,339	94,339	89,000	11,000	100,000	9,730	109,730
5	100,000	219.179	111,371	-	-	94,339	5,661	100,000	11,371	111,371
	<b>\$500,000</b>		<b>\$537,191</b>			<b>\$421,236</b>	<b>\$78,764</b>	<b>\$500,000</b>	<b>\$37,191</b>	<b>\$537,191</b>

### Scenario 2: Lease liability is remeasured at the end of Year 3

Assume the same facts as in Scenario 1, except that at the end of Year 3, LE constructs leasehold improvements that will have significant economic value to LE at the end of the original five-year lease term. Because of this triggering event, LE reassesses the lease term, determining it is now reasonably certain to exercise the two-year extension option. That is, at the end of Year 3, LE reassesses the remaining lease term to be four years (two years remaining from the original lease term plus the two-year extension period).

Accordingly, LE remeasures the lease liability based on a revised discount rate for the lease at the remeasurement date and updated lease payments for the revised lease term. And because the lease payments are remeasured for a change in the lease term, LE also remeasures the variable lease payments based on CPI using the CPI index at the remeasurement date, which is 210.228. LE's incremental borrowing rate at the end of Year 3 is 7%, taking into consideration the remaining, revised lease term and the updated lease payments.

The remeasured lease liability is \$361,832 (four payments of \$106,823 discounted at 7%).

LE reassesses the lease classification, based on the facts and circumstances as of the reassessment date, and determines that the lease is still an operating lease.

LE calculates the remaining cost for the lease as follows.

Total lease payments (including those paid and those not yet paid), reflecting the adjustment resulting from the remeasurement – i.e. \$100,000 for the first 3 years and \$106,823 for the 4 remaining years	\$ 727,292
Plus: Total initial direct costs attributable to the lease	-
Less: Periodic lease cost recognized in prior periods	(300,000)
<b>Remaining lease cost for the lease</b>	<b>\$ 427,292</b>

LE will recognize a single lease cost, calculated so that the remaining cost of the lease is allocated over the remaining lease term on a straight-line basis – i.e. \$106,823 per year for each of the remaining four years.

The following chart summarizes LE's accounting for the lease before and after the remeasurement. The chart assumes that the actual outcomes during the lease term (CPI index) are known by LE at lease commencement.

Year	Base pmts.	CPI index	Actual pmts.	End. ROU asset	End. lease liab.	Single lease cost				Variable lease cost	Total lease cost
						ROU asset amort.	Lease liab. accret.	Single lease cost			
0	\$ -	196.800	\$ -	\$421,236	\$421,236	\$ -	\$ -	\$ -	\$ -	\$ -	
1	100,000	201.800	102,541	346,510	346,510	74,726	25,274	100,000	2,541	102,541	
2	100,000	210.036	106,726	267,301	267,301	79,209	20,791	100,000	6,726	106,726	
3	100,000	210.228	106,823	183,339	183,339	83,962	16,038	100,000	6,823	106,823	
<b>Remeasurement of lease liability and ROU asset</b>						361,832	361,832				
4	106,823	215.949	109,730	280,337	280,337	81,495	25,328	106,823	2,907	109,730	

Year	Base pmts.	CPI index	Actual pmts.	End. ROU asset	End. lease liab.	Single lease cost				Variable lease cost	Total lease cost
						ROU asset amort.	Lease liab. accret.	Single lease cost			
5	106,823	219.179	111,371	193,138	193,138	87,199	19,624	106,823	4,548	111,371	
6	106,823	222.454	113,036	99,835	99,835	93,303	13,520	106,823	6,213	113,036	
7	106,823	224.765	114,210	-	-	99,835	6,988	106,823	7,387	114,210	
	<b>\$727,292</b>		<b>\$764,437</b>			<b>\$599,729</b>	<b>\$127,563</b>	<b>\$727,292</b>	<b>\$37,145</b>	<b>\$764,437</b>	



### Example 6.6.90 Remeasurement and reallocation of the consideration in the contract

#### Original lease

Lessee LE leases a machine from Lessor LR for three years. As part of the contract, LR will maintain the machine for LE. The following facts about the underlying lease (an operating lease, properly classified) are relevant at the lease commencement date.

Fixed payments:	Fixed payments of \$120,000 per year (paid in arrears)
Transfer of ownership:	No
Options:	A single two-year extension option, not reasonably certain of exercise at lease commencement
Fair value of machine:	\$600,000
Remaining economic life of machine:	8 years
RVG:	The first \$50,000 that the residual value is below \$350,000  If the extension option is exercised, the first \$50,000 that the residual value is below \$220,000
Amount probable of being owed under the RVG:	\$18,000
LE's incremental borrowing rate:	7% (implicit rate cannot be readily determined)

Based on the information above, the consideration in the contract is \$378,000.

Fixed payments:	\$360,000 (\$120,000 × 3 years)
Amount probable of being owed under the RVG:	\$18,000

LE concludes that the contract has two components, the machine lease and the (non-lease) machine maintenance, and allocates the consideration in the contract to those components as follows.

Component	Stand-alone price	Allocation	Calculation
Machine lease	\$330,000	\$315,000	$(330,000 / 396,000) \times 378,000$
Maintenance	66,000	63,000	$(66,000 / 396,000) \times 378,000$
	<b>\$396,000</b>	<b>\$378,000</b>	

At lease commencement, LE recognizes a lease liability and an ROU asset based on rental payments of \$100,000<sup>1</sup> per year and a residual value guarantee payment of \$15,000<sup>2</sup> at the end of Year 3.

Lease liability: <sup>3</sup>	\$274,676
ROU asset: <sup>4</sup>	\$274,676

Notes:

1.  $(\$330,000 / \$396,000) \times \$120,000$  annual rental payment = \$100,000.
2.  $(\$330,000 / \$396,000) \times \$18,000$  end-of-lease RVG payment = \$15,000.
3. Present value of the unpaid lease payments (3 annual payments of \$100,000 and one residual value guarantee payment of \$15,000 probable of being owed at the end of the lease term), discounted at 7%.
4. Equal to the lease liability because there are no initial direct costs, no lease incentives or rent prepayments.

### Lease reassessment

At the end of Year 2, LE decides to exercise its two-year renewal option, triggering a reassessment of the lease term. At that date, the following facts are relevant.

Remaining, reassessed lease term:	3 years
Lease payments:	Fixed payments of \$120,000 per year (paid in arrears)
Remaining options:	None
RVG:	The first \$50,000 that the residual value is below \$220,000
Amount probable of being owed under the RVG:	\$6,000
LE's incremental borrowing rate:	6%

Based on the information above, the remaining consideration in the contract is \$366,000.

Fixed payments:	\$360,000 ( $\$120,000 \times 3$ years)
Amount probable of being owed under the RVG:	\$6,000

LE reallocates the remaining consideration in the contract to the machine lease and the machine maintenance based on relative stand-alone prices at the remeasurement date.

Component	Stand-alone price	Allocation	Calculation
Machine lease	\$335,000	\$306,525	$(335,000 / 400,000) \times 366,000$
Maintenance	65,000	59,475	$(65,000 / 400,000) \times 366,000$
	<b>\$400,000</b>	<b>\$366,000</b>	

At the end of Year 2, before the reassessment of the lease term, the balance of the ROU asset and the lease liability is:

Lease liability:	\$107,476
ROU asset:	\$97,476

Due to the change in the lease term, and based on the allocation of the remaining consideration in the contract, LE remeasures the lease payments at \$306,525, which is based on:

- allocated rental payments of \$100,500<sup>1</sup> per year; and
- an allocation of the residual value guarantee payment at the end of the revised lease term, equal to \$5,025<sup>2</sup>.

This results in a lease liability and an ROU asset immediately after the remeasurement of:

Lease liability: <sup>3</sup>	\$272,857
ROU asset: <sup>4</sup>	\$262,857

LE recognizes the adjustment from the remeasurement with the following journal entry; there is no income statement effect of the remeasurement.

	Debit	Credit
ROU asset <sup>5</sup>	165,381	
Lease liability <sup>5</sup>		165,381
<i>To remeasure ROU asset and lease liability following reassessment of lease term.</i>		

Notes:

1.  $(\$335,000 / \$400,000) \times \$120,000$  annual payment = \$100,500.
2.  $(\$335,000 / \$400,000) \times \$6,000$  end-of-lease RVG payment = \$5,025.
3. Present value of the unpaid lease payments (three annual payments of \$100,500 paid in arrears, and one probable residual value guarantee payment of \$5,025 at the end of the lease term), discounted at 6%.
4.  $\$97,476 + (\$272,857 - \$107,476) = \$262,857$ .
5.  $\$272,857 - \$107,476 = \$165,381$ .



### Question 6.6.130

#### Remeasurement of non-lease components

**Should a lessee account for the effect of a remeasurement of a non-lease component on a cumulative effect or prospective basis?**

**Interpretive response:** We believe either approach is acceptable because Topic 842 does not address lessee accounting for non-lease components – e.g. how a lessee should recognize the cost of a non-lease component.

Consider the fact pattern in Example 6.6.90. Lessee LE initially allocates \$63,000 to the three-year non-lease maintenance component of the contract. Assuming that the maintenance is effectively a stand-ready obligation on the part of Lessor LR (which may not always be the case), absent the remeasurement outlined in Example 6.6.90, LE would likely recognize that allocated amount as operating expense ratably over the three-year lease term (which is also the maintenance period). However, after the remeasurement, LE allocates \$59,475 of the remaining consideration in the contract to the remaining three years of maintenance services.

Consequently, LE might account for the remeasurement as a true-up to a five-year maintenance service, with a total price of \$101,475.<sup>1</sup> In that case, LE would recognize contra-expense of \$1,410<sup>2</sup> at the time of remeasurement, with an offsetting accrual for that amount. However, because the remeasurement results from a change in estimate, we believe it would be more appropriate for LE to simply account for the remaining maintenance services to be provided over the final three years of the revised lease term prospectively; this is consistent with how LE will account for the remainder of the lease. Therefore, LE would recognize the \$59,475 allocated to the maintenance services ratably over the remaining three-year lease term after the remeasurement; no contra-expense amount would be recognized at the remeasurement date.

Notes:

1.  $([\$63,000 \text{ initial allocation to the 3-year maintenance service} / 3 \text{ years}] \times 2 \text{ years}) + \$59,475 \text{ allocation after the remeasurement at the end of Year 2} = \$101,475.$
2.  $\$40,590 \text{ (which equals } [\$101,475 / 5 \text{ years}] \times 2 \text{ years}) - \$42,000 ([\$63,000 / 3 \text{ years}] \times 2 \text{ years}) = \$(-1,410).$



## Comparison to legacy US GAAP

### **Requirement to remeasure lease liability represents a significant change from capital lease accounting under Topic 840**

6.6.200 A requirement to potentially remeasure the lease liability during the lease term is a significant change from Topic 840 requirements for capital leases where the liability was not remeasured during the lease term unless the lease was modified. [840-30-35-17]

### **Residual value guarantees**

6.6.210 Under Topic 840, any amounts expected to be payable under a residual value guarantee within an operating lease were accrued separately. For a capital lease, the full amount of the residual value guarantee was included in the determination of the capital lease obligation and the capital lease asset and was not separately accounted for. [840-10-25-6(b), 840-20-35-1]

### **Updating the discount rate for the lease**

6.6.220 Topic 842's requirement to reassess the discount rate for the lease in specified cases of remeasurement (see paragraph 6.6.150) represents a shift from Topic 840 for capital leases where a lessee, subject to certain requirements, used the initial discount rate that was determined at lease

inception to calculate the change in the lease liability as a result of a change in the amount of remaining minimum lease payments due to a lease modification.  
[840-30-35-8]

## 6.7 Lease modifications (Step 8B)



### Excerpt from ASC 842-10

#### 25 Recognition

##### General

> Lease Modifications

**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.

• > Lessee

**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.

**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**.

**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.

**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.

## 55 Implementation Guidance and Illustrations

### General

- > Implementation Guidance
  - > Lease Modifications
    - • > Lease Modifications in Connection with the Refunding of Tax-Exempt Debt

**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.

- • > Master Lease Agreements

**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 the master lease agreement permits the lessee to gain control over the use of additional underlying assets during the term of the agreement but does not commit the lessee to doing so, the lessee's taking control over the use of an additional underlying asset should be accounted for as a lease modification in accordance with paragraphs 842-10-25-8 through 25-18.

> Illustrations

• > Illustrations of Lease Modifications

**55-159** Examples 15 through 22 illustrate the accounting for lease modifications.

• • > Lessee

• • • > Example 15—Modification Accounted for As a Separate Contract

**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.

• • • > 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).

• • • > 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.

• • • > 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).

**55-171** Lessee allocates the lease payments in the modified contract to the 2 separate lease components on a relative standalone price basis, which, in this Example, results in the allocation of \$388,889 to the original space lease and \$311,111 to the additional space lease. The allocation is based on the remaining lease terms of each separate lease component (that is, 5 years for the original 10,000-square-foot lease and 4 years for the additional 10,000-square-foot lease). The remaining lease cost for each separate lease component is equal to the total payments, as allocated, which will be recognized on a straight-line basis over their respective lease terms. Lessee remeasures the lease liability for the original space lease as of the effective date of the modification—the lease classification of which does not change as a result of the modification—on the basis of all of the following:

- a. A remaining lease term of 5 years
- b. Annual allocated lease payments of \$77,778 in Years 6 through 10 (see paragraph 842-10-55-173)
- c. Lessee's incremental borrowing rate at the effective date of the modification of 7 percent.

**55-172** The remeasured lease liability for the original space lease equals \$318,904. Lessee recognizes the difference between the carrying amount of the modified lease liability and the carrying amount of the lease liability immediately before the modification of \$102,332 (\$421,236 – \$318,904) as an adjustment to the right-of-use asset.

**55-173** During Year 6, Lessee recognizes lease cost of \$77,778. At the end of Year 6, Lessee makes its lease payment of \$100,000, of which \$77,778 is allocated to the lease of the original office space and \$22,222 is allocated to the lease of the additional office space as a prepayment of rent. Lessee allocates the lease payment in this manner to reflect even payments for the even use of the separate lease components over their respective lease terms.

**55-174** At the commencement date of the separate lease component for the additional office space, which is 1 year after the effective date of the modification, Lessee measures and recognizes the lease liability at \$241,896 on the basis of all of the following:

- a. A lease term of 4 years
- b. Four allocated annual payments of \$72,222 ([allocated lease payments of \$311,111 – \$22,222 rent prepayment] ÷ 4 years)
- c. Lessee's incremental borrowing rate at the commencement date of the separate lease component for the additional office space of 7.5 percent.

**55-175** At the commencement date, the right-of-use asset for the additional office space lease component is recognized and measured at \$264,118 (the

sum of the lease liability of \$241,896 and the prepaid rent asset of \$22,222).

**55-176** During Years 7–10, Lessee recognizes lease cost of \$77,778 each year for each separate lease component and allocates each \$150,000 annual lease payment of \$77,778 to the original office space lease and \$72,222 to the additional office space lease.

••• > Example 18—Modification That Decreases the Scope of a Lease

**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 ( $\$284,669 \div \$590,767$ ) 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.

**55-182** Lessee decreases the carrying amount of the right-of-use asset to reflect the partial termination of the lease based on the adjustment to the carrying amount of the lease liability, with any difference recognized in profit or

loss. The premodification right-of-use asset is \$514,436. Therefore, at the effective date of the modification, Lessee reduces the carrying amount of the right-of-use asset by \$247,888 ( $48.2\% \times \$514,436$ ). 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

**55-183** Lessee determines the proportionate decrease in the carrying amount of the right-of-use asset based on the remaining right-of-use asset (that is, 5,000 square feet corresponding to 50 percent of the original right-of-use asset).

**55-184** Fifty percent of the premodification right-of-use asset is \$257,218 ( $50\% \times \$514,436$ ). Fifty percent of the premodification lease liability is \$295,384 ( $50\% \times \$590,767$ ). 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.

**55-185** Lessee recognizes the difference between the remaining lease liability of \$295,384 and the modified lease liability of \$306,098 (which equals \$10,714) as an adjustment to the right-of-use asset reflecting the change in the consideration paid for the lease and the revised discount rate.

• • • > 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 \$40,206 ( $\$429,171$  premodification lease liability – \$388,965 modified lease liability) as a corresponding reduction to the right-of-use asset. Therefore, the adjusted right-of-use asset equals \$376,465 as of the effective date of the modification. Lessee calculates its remaining lease cost as \$462,500 (the sum

of the total lease payments, as adjusted for the effects of the lease modification, of \$960,000 reduced by the total lease cost recognized in prior periods of \$497,500), which it will recognize on a straight-line basis over the remaining lease term.

**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.

	<b>Lease Liability</b>	<b>Right-of-Use Asset</b>
<b>Year 7</b>	\$ 251,816	\$ 241,316
<b>Year 8</b>	\$ 174,443	\$ 166,443
<b>Year 9</b>	\$ 90,654	\$ 86,154
<b>Year 10</b>	\$ -	\$ -

6.7.10 A lease modification is a change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease – e.g. a change to the terms and conditions of the contract that adds or terminates the right to use one or more underlying assets or extends or shortens the contractual lease term is a lease modification. [842 Glossary]



### Question 6.7.05

#### Contract modifications not in writing

## Do contract modifications have to be in writing?

**Interpretive response:** No. Under Topic 842, a contract can be oral or implied as long as it creates enforceable rights and obligations on the contracting parties. Similarly, a modification to a contract can also be oral or implied, as long as it is enforceable. [842 Glossary]

An example of an implied modification is lessee construction or installation of lessor-owned improvements to the underlying asset – e.g. structural improvements to a lease building – not required by the lease contract. Even if no amendment is executed, it is implied that the lessor agreed to the lessee's actions. See Question 5.4.85 for further discussion.

Additional examples of contract modifications that may not result in or from written changes to the terms and conditions of the lease contract include the following (not exhaustive).

- Substituting the underlying asset, even if permitted or required by the contract – e.g. replacing Asset 1 with equivalent Asset 2.
- Significantly modifying or enhancing the underlying asset such that it is, in substance, a different asset – e.g. significantly enhancing the capacity and efficiency of a power-generating facility.
- Decreasing or increasing the number of assets subject to a lease agreement that does not specify the number of assets is accounted for as a lease modification. For example, a lease for a lessor's entire fleet of a particular asset is considered modified if the size (number of assets) and/or composition (some assets are replaced with other assets) of the fleet changes. See also Example 6.7.40. [842-10-55-17 – 55-18]



### Question 6.7.06

#### **Contract changes only affecting variable or contingent payments**

#### **Does a lease contract change that affects only variable or contingent payments for the lease qualify as a lease modification?**

**Background:** A lessor and lessee may modify the terms of a lease contract in a manner that *only* adds new, or changes existing, variable or contingent lease payments. Relevant examples could include adding or changing:

- a variable payment based on a percentage of the lessee's sales or the lessee's usage of the underlying asset;
- a payment that changes based on increases or decreases in the CPI; or
- a contingency in the lease contract that could change the amount of the payments the lessee will make under the lease.

In these circumstances, the 'lease payments' (see section 5.4) and/or the 'consideration in the contract' (see section 4.3) may not change, so some have questioned whether these changes are lease modifications under Topic 842.

**Interpretive response:** Yes. A lease modification is a change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease (see paragraph 6.7.10). Variable and contingent payments are part of the consideration for a lease; therefore, changes to (including the addition of) such payments change the consideration for the lease and give rise to a lease modification.



## Question 6.7.07

**Are rent concessions lease modifications?****Is a rent concession a lease modification?**

**Applicability:** This question does not apply to eligible COVID-19 related concessions of a lessee that has elected the practical expedient offered by the FASB staff specific to COVID-19 related rent concessions. If the lessee has elected the practical expedient and the rent concession in question is COVID-19 related, see KPMG Hot Topic, [FASB staff guidance on accounting for COVID-19 rent concessions](#).

**Background:** Rent concessions may be offered by lessors or negotiated by lessees when temporary circumstances arise – e.g. temporary closure or changes to operating hours due to COVID-19, civil unrest or a natural disaster.

Examples of rent concessions include (not exhaustive):

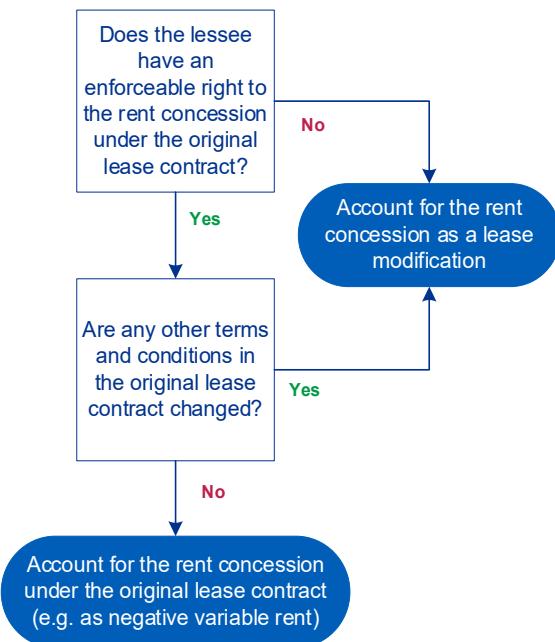
- forgiveness of contractually owed past-due rent;
- rent abatements (i.e. decreased rent payments) for future periods – e.g. 50% discount from the original rent payments for the next six months; and
- interest-free rent deferrals.

Accounting for rent concessions under Topic 842, regardless of whether proactively offered by the lessor or negotiated by the lessee, depends on the enforceable rights and obligations of the lessee under the original contract, and the nature of any contractual changes agreed by the parties.

**Interpretive response:** It depends. We believe the first step to answer this question is to determine whether:

- the lessee had an enforceable right to the concession before it was granted; and
- other terms and conditions of the contract that affect the scope of or consideration for the lease were changed.

The following diagram illustrates the evaluation and its result on the lessee's accounting.



### Enforceable right

Lease contracts may contain force majeure or similar clauses that apply in the event that unforeseen circumstances prevent the parties to the lease contract from fulfilling their obligations under (or obtaining their anticipated benefits from) the contract. These clauses may provide for free, reduced or deferred rent for the period until the unforeseen circumstances are remedied, after which rent payments return to the normal amounts as specified under the original lease agreement. Alternatively, they may provide for prospective rent abatements that are intended to compensate the lessee for the effect of the unforeseen circumstances.

Even if not written into the original lease contract, a lessee may still have an enforceable right to a rent concession based on the laws of the jurisdiction governing the lease contract and that apply to the lease contract. Whether a force majeure or similar clause applies, or whether a lessee otherwise has an enforceable right to a rent concession, is ultimately a legal question that must be answered based on applicable law and the facts and circumstances giving rise to the evaluation.

### Changes to other terms and conditions

If the lessee has a contractual, or otherwise enforceable, right to the rent concession, there may still be a lease modification, requiring the lessee to undertake lease modification accounting. This is the case if other terms and conditions of the original lease contract affecting the scope of or consideration for the lease are changed in connection with the rent concession.

In the event of a rent concession, the two parties will be communicating, and they may take the opportunity to agree on other changes to the contract. For example, the parties may agree on a change to the lease term and/or changes to the lease payments, including variable payment terms, not required by a

force majeure clause or the lessee's other enforceable rights. In general, changes to the terms and conditions of the contract (which can be written, verbal or otherwise – see Question 6.7.05) that affect the scope of or the consideration for the lease other than merely communicating or agreeing on the amount of a rent concession for the affected periods of the lease, will trigger a lease modification. This is the case even if the impetus for the negotiation was the force majeure event.

Even if no other terms and conditions are explicitly changed, careful consideration should be given to the rent concession. If the substance of the rent concession is that it is clearly not related solely to the force majeure event, a lease modification has likely occurred. For example, the amount of the concession may be disproportionate to the effects of the force majeure event, or an additional concession might be offered to induce the lessee to extend or not terminate the lease.

### Rent deferrals – concession or not?

Agreement by the lessor to defer contractually owed lease payments or variable lease payments is a rent concession.

Consistent with rent forgiveness or abatement concessions, if the lessee does not have an enforceable right to the rent deferral, granting of this concession by the lessor, changing the payment terms and in effect granting the lessee an interest-free loan, is a lease modification.

### Concession required but amount uncertain

In some cases, the lessor and lessee may agree that the lessee has an enforceable right to the rent concession under the circumstances, but the amount of the rent forgiveness or abatement, or duration of the interest-free deferral, to which the lessee is entitled, is uncertain. Neither the contract, nor the laws of the relevant jurisdiction, may clearly articulate how to determine the required concession.

For example, if a shopping center has reduced operating hours, it may be unclear how a required rent reduction should be calculated – e.g. pro rata based on the decreased number of operating hours as compared to normal, or on some other basis if the changed operating hours disproportionately affect low or high-traffic times, such as dinner hours for a restaurant in the food court.

In these cases, we believe that agreeing on the amount or duration of a contractually required concession does not in isolation trigger a lease modification. This is consistent in concept with established practice that the two parties to a lease agreeing on the amount of a contractually required fair market rent lease payment adjustment does not constitute a lease modification.

However, a lease modification will generally still result if other terms and conditions of the lease contract affecting the scope of or consideration for the lease are changed in connection with communicating or agreeing on the amount of the rent concession (see above).

### Accounting consequences

If there is a lease modification, lessees will account for the modification consistent with any other modification.

If the lessee has an enforceable right to the rent concession for the affected period(s) and there are no other changes to the terms and conditions of the original lease contract, there is no lease modification. The lessee should continue to account for the lease under the original contract. In the case of a rent forgiveness or a temporary rent abatement, we believe the lessee should generally account for that rent reduction as negative variable lease cost, consistent with lessee accounting for a co-tenancy clause (see Question 6.6.60).



## Question 6.7.08

### Lessee short payment of rent – lessee accounting

#### How does a lessee account for making rent payments that are less than the amount contractually owed (i.e. 'short payment')?

**Background:** Some lessees may decide, or be forced by their cash flow circumstances, to make rent payments that are less than the amount that is contractually owed (i.e. 'short pay').

**Interpretive response:** The first step to accounting for a short payment is to determine whether the lessee is entitled to make the short payment under the existing lease contract – i.e. whether, based on the terms and conditions of the contract, the lessee has the enforceable right to pay the lesser rent amount.

If so, we believe the lessee should generally account for the rent reduction as *negative* variable lease cost of the period to which the short payment relates. This is consistent with lessee accounting for a co-tenancy clause (see Question 6.6.60).

If the enforceable rights and obligations of the lease contract do not permit the lessee to short pay the rent, lease cost will not change for the periods of short payment, and no remeasurement of the lease liability will occur, before a modification is approved – i.e. the parties agree to a change to the terms and conditions of the lease.

If a modification is approved, the lessee will apply modification accounting as illustrated throughout this section 6.7 from the 'effective date of the modification' (see paragraph 6.7.20), treating any forgiven past due rent as a lease incentive in accounting for the modified lease.

**Note:** An exception to the preceding paragraph arises if the modification is a concession (see Question 6.7.07) resulting from COVID-19, the concession qualifies for the FASB staff's practical expedient for COVID-19 related rent concessions and the lessee has elected the optional practical expedient to account for the concession as if it was required under the original lease contract. See KPMG Hot Topic, [FASB staff guidance on accounting for COVID-19 rent concessions](#), for guidance.



## Example 6.7.08

**Lessee accounting for short payments not permitted by the contract**

Lessee LE enters into a contract with Lessor LR for the right to use retail store space in a shopping mall for 12 months. The right to use the retail space is an operating lease and there are no other components of the contract. LE has not elected the short-term lease recognition exemption.

The following additional facts are relevant.

Lease payments:	12 monthly fixed payments of \$2,000 paid in advance
Renewal options:	None
Termination/purchase options:	None
Transfer of ownership:	No
RVG:	None
LE's incremental borrowing rate:	6%
Initial direct costs (LE):	None

During the lease term, LE will account for the lease liability and the ROU asset as follows (assuming no remeasurements, modifications or impairments).

Mo.	Lease liability				ROU asset			Single lease cost
	Beginning balance	Accretion	Payments	Ending balance	Beginning balance	Amort.	Ending balance	
1	\$21,354	\$107	(\$2,000)	\$19,461	\$23,354	(\$1,893)	\$21,461	\$2,000
2	19,461	97	(2,000)	17,558	21,461	(1,903)	19,558	2,000
3	17,558	88	(2,000)	15,646	19,558	(1,912)	17,646	2,000
4	15,646	78	(2,000)	13,724	17,646	(1,922)	15,724	2,000
5	13,724	69	(2,000)	11,793	15,724	(1,931)	13,793	2,000
6	11,793	59	(2,000)	9,852	13,793	(1,941)	11,852	2,000
7	9,852	49	(2,000)	7,901	11,852	(1,951)	9,901	2,000
8	7,901	39	(2,000)	5,940	9,901	(1,961)	7,940	2,000
9	5,940	30	(2,000)	3,970	7,940	(1,970)	5,970	2,000
10	3,970	20	(2,000)	1,990	5,970	(1,980)	3,990	2,000
11	1,990	10	(2,000)	-	3,990	(1,990)	2,000	2,000
12	-	-	-	-	2,000	(2,000)	-	2,000

Due to unforeseen circumstances (not COVID-19), LE short pays Months 5 and 6. LE pays \$1,000 each month instead of the contractually required \$2,000.

LE does not have an enforceable right to short pay those months' rent and LR has not agreed to accept the reduced payments in lieu of the contractual amounts owed. Therefore, LE and LR continue to account for the lease under its original terms and conditions.

The contract stipulates that LE incurs a monthly 1% interest charge on any past due rent (plus accrued interest).

As a result, LE records the following journal entries in Months 5 and 6.

	Month 5		Month 6	
	Debit	Credit	Debit	Credit
Operating lease expense <sup>1</sup>	2,000		2,000	
Lease liability <sup>2</sup>	1,931		1,941	
Interest expense <sup>3,4</sup>	10		20	
ROU asset		1,931		1,941
Cash		1,000		1,000
Accounts payable <sup>5</sup>		1,000		1,000
Interest payable <sup>6</sup>		10		20

Notes:

1. Straight-line lease cost. This amount does not change from what LE would have recognized had it paid Months 5 and 6 rent in full and on time.
2. \$2,000 contractual payment (50% paid in cash, 50% reclassified to accounts payable) – lease liability accretion for the month (\$69 in Month 5, \$59 in Month 6).
3. For Month 5: short payment of  $\$1,000 \times 1\% = \$10$ .
4. For Month 6: (Months 5 and 6 short payments (\$2,000) + Month 5 accrued interest (\$10))  $\times 1\% = \$20.10$ . [Rounded in Month 6 journal entry]
5. The unpaid portion of the contractually owed monthly lease payment remains in accounts payable when only 50% of it is paid. LE may elect to present this amount in its current portion of operating lease liabilities on the balance sheet.
6. To record the late payment interest due under the terms of the contract.

### Lease modification

At the beginning of Month 7, LR agrees to forgive the unpaid portion of the Months 5 and 6 rent and interest thereon. The lease remains classified as an operating lease after the modification.

Therefore, at the effective date of the modification (i.e. the beginning of Month 7), LE writes off its existing payables for the unpaid Months 5 and 6 rent and accrued interest forgiven by LR with a corresponding adjustment to the ROU asset, consistent with any other lease incentive. LE records the following journal entry.

	Month 7	
	Debit	Credit
Accounts payable <sup>1</sup>		2,000
Interest payable <sup>2</sup>		30
ROU asset <sup>3</sup>		2,030

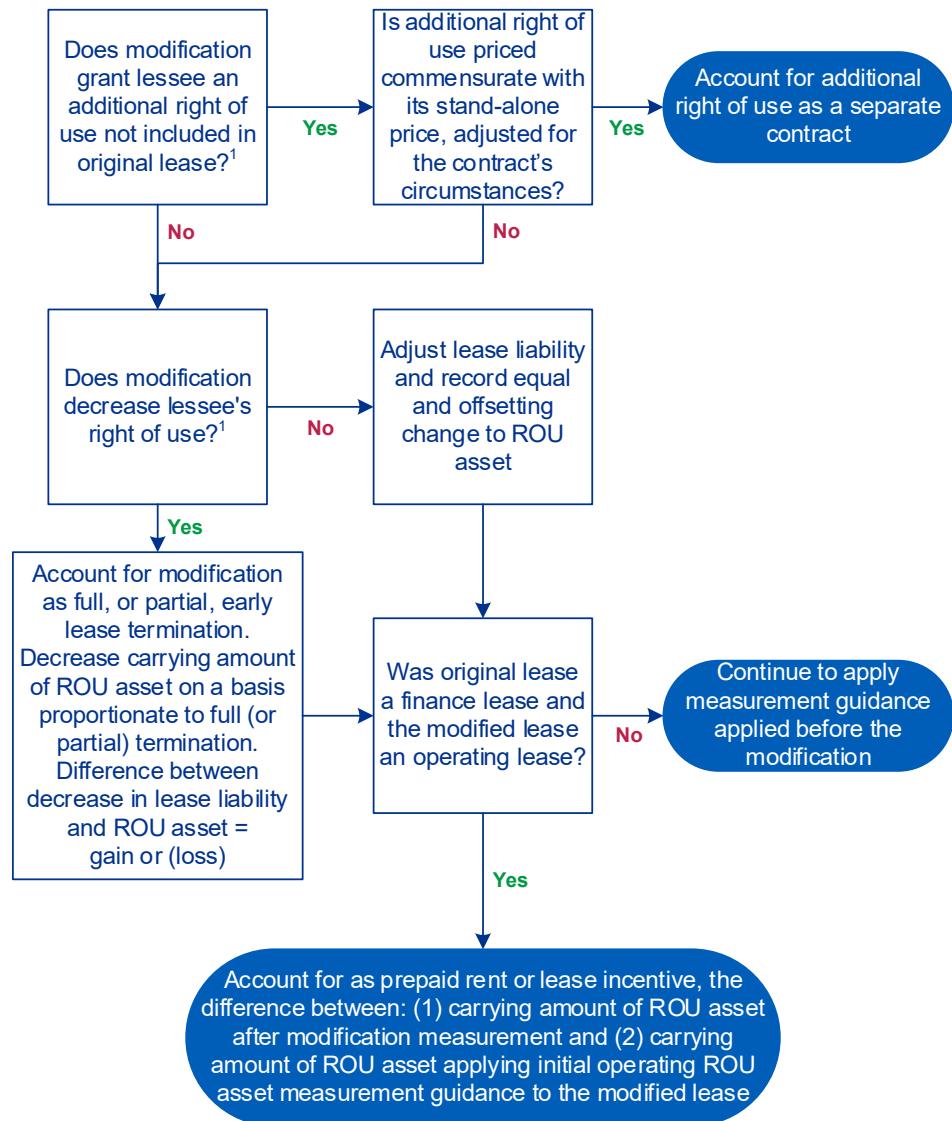
Notes:

1. Calculated as the unpaid portion of the contractually owed monthly lease payment resulting from Month 5 (\$1,000) + Month 6 (\$1,000).
2. Calculated as the Month 5 accrued interest (\$10) + the Month 6 accrued interest (\$20).
3. Reduction to the ROU asset for the payables forgiven.

After recognizing the journal entry, LE accounts for the lease from the effective date of the modification consistent with any other modified lease.

6.7.20 The effective date of a lease modification is the date the modification is approved by both the lessee and the lessor. [842 Glossary]

6.7.30 The following flowchart summarizes the lease modification requirements applicable to a lessee. [842-10-25-8 – 25-14]



Note:

1. Lease term is an attribute of the lessee's right to use the underlying asset – i.e. an extension does not grant the lessee an additional right of use. [842-10-25-11(b)]

6.7.40 An entity accounts for a modification as a separate contract when the following conditions are met: [842-10-25-8]

- the modification grants the lessee an additional right of use that was not included in the original lease – e.g. a right to use an additional asset; and
- the lease payments increase commensurate with the stand-alone price of the additional right of use, adjusted for the circumstances of the contract. For example, the stand-alone price for the lease of one floor in an office building in which the lessee already leases other floors may be different from the stand-alone price of a similar floor in a similar office building because the lessor did not have to incur costs it would have incurred for a new lessee.



### Question 6.7.09

#### **Modifications that add a right(s) of use and make other changes**

#### **Can a contract modification that adds a lessee right of use, but also includes other changes, be accounted for as a separate contract?**

**Background:** To illustrate, consider a scenario in which a lessee leases three floors of an office building for an original term of five years. In Year 3, the lessee enters into an amendment with the lessor to lease a fourth floor. In addition to the fourth floor lease, the lessee and lessor agree to:

- extend the non-cancellable period for the three original floors to match the non-cancellable period of the new, fourth floor lease; and/or
- reduce the lease payments for the original three floors to reflect the price per square foot the lessee is paying for the fourth floor lease.

**Interpretive response:** No. A contract modification can only be accounted for as a separate contract if the only change to the existing contract is to add an additional right of use to the contract – e.g. adding another floor to an existing office space lease as in the background example. [842-10-25-8]

If changes are also made to one or more existing lease components, the separate contract guidance in paragraph 842-10-25-8 does not apply. In that case, it is not appropriate to bifurcate the additional right of use and the other changes, and assess the additional right of use separately under the separate contract guidance. [ASU 2016-02.BC171-BC172]

6.7.50 The accounting steps an entity performs for a lease modification that is not accounted for as a separate contract are similar to the steps a lessee performs when remeasuring lease liabilities for changes in the lease term or in the assessment of a lessee purchase option, with some differences for Steps 3 and 4 described below. [842-10-25-9 – 25-13]

#### **Accounting steps for a lease modification not accounted for as a separate contract**

1. Remeasure and reallocate the consideration in the contract to the remaining lease and non-lease components of the contract at the effective date of the modification using then-current stand-alone prices (see chapter 4).

### Accounting steps for a lease modification not accounted for as a separate contract

2. Remeasure the lease liability to reflect the revised lease payments, using a discount rate for the lease (see section 5.6) determined at the effective date of the modification.<sup>1</sup>
3. Either:
  - a. If the modification decreases the lessee's ROU (e.g. reduces the number of assets leased or reduces the space leased in a building), the carrying amount of the ROU asset is reduced on a proportionate basis to the full (or partial) termination of the existing lease; and any difference between the reduction in the lease liability and the reduction in the ROU asset is recognized as a gain (loss) at the effective date of the modification.
  - b. Otherwise,<sup>2</sup> adjust the amount of the ROU asset by the amount of the remeasurement of the lease liability.
4. Account for initial direct costs (see section 5.5), lease incentives (see section 5.4.3), and other payments in connection with the modification in the same manner as for a new lease.
5. Reassess lease classification in accordance with paragraph 842-10-25-1 as of the effective date of the modification.
6. If there is a change in lease classification, adjust the remaining lease cost recognition pattern and presentation in the income statement and statement of cash flows prospectively.

Notes:

1. When a lessee remeasures the lease liability, variable lease payments that depend on an index or rate are measured using the index or rate as of the remeasurement date. The Board decided that a lessee should remeasure variable lease payments that depend on an index or a rate when the lessee remeasures the lease liability for another reason because it would not be logical to use an outdated index or rate in remeasuring the lease payments [842-10-35-5, ASU 2016-02.BC237]
2. Including modifications that: [842-10-25-11]
  - grant the lessee an additional right of use not included in the original contract (and that modification is not accounted for as a separate contract);
  - change the term of an existing lease (e.g. extend or reduce the lease term), other than through the exercise of an extension or termination option included in the original contract; or
  - change the consideration in the contract only.



### Observation

#### Lease modifications vs. lease remeasurements resulting from reassessments

6.7.60 The decisions by the Board to consider the lease term an attribute of the lease and to require a reassessment of lease classification for lease modifications that are not accounted for as a separate contract substantially aligns the lease modification guidance with the lease reassessment guidance. This minimizes accounting differences between the two models that could have created structuring opportunities. [ASU 2016-02.BC176(b)]

6.7.70 If a finance lease is modified and the modified lease is classified as an operating lease, the lessee accounts for (in the manner of a rent prepayment or a lease incentive) the difference between: [842-10-25-14]

- the carrying amount of the ROU asset immediately after remeasurement as a result of the modification; and
- the carrying amount of the ROU asset that would result from applying the initial measurement guidance for an operating lease ROU asset to the modified lease.



### Example 6.7.10

#### Modification that adds a right of use

##### Scenario 1: Modification is accounted for as a separate contract

Assume the same facts as in Examples 6.3.10 and 6.4.20, in which Lessee LE leases office space from Lessor LR. At the beginning of Year 7, LE and LR modify their contract to grant LE the right to use an additional floor of office space in the same building as the current office space LE leases from LR for four years (making the non-cancellable period coterminous with that of the original office space lease), with an option to renew the new space lease for five years (consistent with the option LE has to renew the original office space lease). The new office space is the same size as the original office space and is similar in all significant respects.

The lease payments for the new office space are 5% lower each year than the lease payments for the original office space – the lease payments for the original office space continue to be considered market rentals for office space of that size and characteristics.

Because of its existing relationship with LE, LR was able to obtain this lease without incurring any marketing or commission costs and was able to forgo costs such as those for a credit check because LE is already a tenant in good standing.

LE (and LR) conclude that this modification should be accounted for as a separate contract – i.e. separate from the original contract that granted LE the right to use the original office space. This conclusion is based on the following.

- The modification grants LE an additional right of use – i.e. the right to use an additional floor of office space.
- The increase in the lease payments for the additional office space is commensurate with the stand-alone price for the right to use that office space based on the circumstances of this contract. Even though the lease payments for the new office space are 5% below market rentals, the lower lease payments are reflective of sharing with LE the benefit of LR not having to incur origination costs to obtain this lease – i.e. as noted above, LR did not have to market the property or pay a broker's commission to obtain the new office space lease and did not have to incur other common origination costs.

Therefore, in accounting for the new office space lease, LE does not modify the accounting for the original office space lease. LE accounts for the new office space lease just as it would any other new lease.

**Scenario 2: Modification is not accounted for as a separate contract**

Assume the same facts as in Scenario 1, except that the lease payments are discounted 20% from those in the original office space lease, the payments for which are still considered to be market rentals.

LE (and LR) conclude that this modification should not be accounted for as a separate contract. Even though, consistent with Scenario 1, the modification grants LE an additional right of use, the increase in the lease payments resulting from the additional right of use is not commensurate with the stand-alone price for that additional right of use, even after considering the factors outlined in Scenario 1 as to the particular circumstances of obtaining this additional lease. The discount from market rentals cannot be considered entirely attributable to the origination costs LR will not have to incur to obtain the new office space lease.

In this scenario, because the new office space lease is commencing immediately, and both leases have the same lease term, it does not matter whether LE accounts for the original office space lease and the new office space lease as separate lease components. However, if the new office space lease commenced at the beginning of Year 8, rather than at the beginning of Year 7, LE would separately account for the two lease components (original office space and new office space), remeasuring the original lease component for the modification (i.e. for the change in the lease payments that will result from allocating a portion of those lease payments to the new office space lease) as of the effective date of the modification. LE would recognize and measure the new office space lease at the commencement date for that lease.

**Scenario 3: Blend and extend**

Assume the same facts as in Scenario 2, except that the right to use the new office space is for a non-cancellable period of nine years from the effective date of the modification and, as part of the modification, the right to use the original office space is made coterminous with the new office space – i.e. LE also commits to lease the original office space for nine years from the effective date of the modification. In addition, the lease payments for the original office space are reduced to match those for the additional office space.

At the beginning of Year 7 of the original lease (which is the effective date of the modification in this example), the carrying amount of the ROU asset and the lease liability were (see Example 6.4.20):

Lease liability:	\$57,306
ROU asset:	\$53,350

At the effective date of the modification, the following facts are relevant.

Rate implicit in the lease:	Not readily determinable
LE's incremental borrowing rate:	9%
RVG:	None
Options:	There are no lessee or lessor options in the contract
Transfer of ownership:	No

Fair value of the combined office space:	\$840,000
Remaining economic life of the office space:	29 years
Additional initial direct costs incurred:	\$1,000

Because LE's right to use the new office space commences on the effective date of the modification, LE is not required to account for the original office space and the new office space as separate lease components. LE concludes that the single, modified lease component in the contract (for two floors of office space for nine years) is an operating lease.

The lease payments for the modified contract are as follows (calculated based on contractual lease payments from Example 6.3.10 starting in Year 7  $\times 80\% \times 2$ ).

Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8	Yr 9	Total
\$27,754	\$28,586	\$29,445	\$30,326	\$31,236	\$32,174	\$33,140	\$34,132	\$35,156	\$281,949

The lease liability for the modified lease is \$184,674 (the present value of the nine annual lease payments, discounted at 9%). Therefore, LE increases its existing lease liability by \$127,368 (\$184,674 – \$57,306). The offset to that adjustment is to the existing ROU asset. LE accounts for the initial direct costs incurred in connection with the modification in the same manner as it would for a new lease. Therefore, LE recognizes the additional \$1,000 in initial direct costs that it incurs as an addition to its remeasured ROU asset.

Consequently, LE records the following journal entry at the effective date of the modification.

	Debit	Credit
ROU asset	128,368	
Lease liability		127,368
Cash (initial direct costs)		1,000
<i>To recognize lease modification.</i>		

From the effective date of the modification, LE accounts for the modified lease in the same manner as for any other lease; see Example 6.4.20 for an example of subsequent accounting for an operating lease.



## Example 6.7.20

### Modification that extends the lease term only

#### Modification that extends the lease term only

Assume all of the same facts as in Example 6.6.50 (remeasurement resulting from a change in the lease term) except that, instead of there being a remeasurement event at the end of Year 6, the lease did not contain a renewal option and the lease is modified at the end of Year 6 to extend the total lease term from 10 years to 15 years.

The terms for the extension agreed through the modification and the terms of the renewal option in Example 6.6.50 are the same. That is, Lessee LE and Lessor LR modify the lease to add an additional period of five years to the lease. Lease payments during the extension period start at \$19,523 and increase 3% annually, all payable in arrears. There are no initial direct costs, lease incentives or other payments between LE and LR as a result of the modification.

### Separate contract analysis

Because the modification increases the lease term only (i.e. it does not grant LE an additional right of use), the modification cannot be accounted for as a separate contract.

### Accounting for the modification and accounting for the lease post-modification

The accounting for the modification and the accounting for the modified lease after the modification in this example is the same as the accounting for the remeasurement and the accounting for the lease after the remeasurement in Example 6.6.50. Therefore, see that example for the journal entries recorded to remeasure the lease liability and the ROU asset, as well as the accounting that results post-modification.



### Example 6.7.25

#### Modification – original lease is a finance lease and the modified lease is an operating lease

Assume all of the same facts as in Example 6.4.10: 10-year finance lease of a piece of equipment with a remaining economic life of 12 years and no renewal options.

At the end of Year 3, Lessee LE and Lessor LR modify the lease to reduce the total lease term from 10 to 6 years. There are no initial direct costs, lease incentives or other payments between LE and LR stemming from the modification.

The following additional facts are relevant.

- The modified lease does not transfer title to the equipment to LE.
- The modified lease does not include renewal or purchase options.
- The leased equipment is not specialized or customized.
- The fair value of the equipment as of the effective date of the modification is \$65,000.

### Separate contract analysis

Because the modification decreases the lease term only (i.e. it does not grant LE an additional ROU), the modification cannot be accounted for as a separate contract.

### Non-cancellable lease period

Lease payments under the original lease for the 10-year term were as follows.

Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8	Yr 9	Yr 10	Total
\$14,527	\$14,963	\$15,412	\$15,874	\$16,350	\$16,841	\$17,346	\$17,866	\$18,402	\$18,954	\$166,535

Lease payments under the modified lease are as follows.

Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Total
\$14,527	\$14,963	\$15,412	\$15,874	\$16,350	\$16,841	\$93,967

### Remeasuring the lease liability and ROU asset

In accordance with paragraph 842-10-25-11, LE uses an updated discount rate for the lease determined at the effective date of the modification (i.e. at the end of Year 3). The rate implicit in the lease is not readily determinable. Accordingly, LE uses its incremental borrowing rate at the end of Year 3 (12%) as the discount rate for the modified lease, taking into account:

- a remaining lease term of three years (modified lease term of six years less three years into the original lease term); and
- the remeasured lease payments for the modified remaining lease term of three years.

At the end of Year 3, the carrying amounts of the lease liability and ROU asset immediately before remeasurement are \$83,651 and \$73,500, respectively (see Example 6.4.10).

LE remeasures the lease liability at the present value of the remaining lease payments for the revised lease term (i.e. Years 4–6), discounted at 12%, which is \$39,194 (or a decrease of \$44,457). LE records the following journal entry.

	Debit	Credit
Lease liability	44,457	
ROU asset		44,457
<i>To remeasure lease liability following modification of lease term; corresponding adjustment to ROU asset.</i>		

After this journal entry, the carrying amount of LE's ROU asset is \$29,043 (\$73,500 – \$44,457).

### Lease classification reassessment

LE is required to reassess the original finance classification of the lease (see Example 6.4.10). The remaining economic life of the equipment is 9 years (original remaining economic life of 12 years less three years into the original lease term). Therefore, the reassessed lease is an operating lease.

Unlike at commencement of the original lease, where the lease term was for a major part of the remaining economic life of the equipment (10 year lease term / 12 year remaining economic life = 83%), the modified lease is not for a major part of the remaining economic life of the equipment at the effective date

of the modification (3 year remaining lease term / 9 year remaining economic life = 33%). In addition, based on the facts presented, none of the other finance lease criteria are met.

### Accounting subsequent to remeasurement

Because the original classification of the lease was a finance lease and the modified lease is classified as an operating lease, the difference between:

- the carrying amount of the ROU asset after remeasurement for the modification **[a]** and
- the carrying amount of the ROU asset determined by applying the operating lease ROU asset initial measurement guidance to the modified lease **[b]**

is accounted for

- like prepaid rent (if **[a] > [b]**) or a lease incentive (if **[b] > [a]**) when determining the remaining lease cost for the modified operating lease (see paragraph 6.7.70).

LE calculates the difference between **[a]** and **[b]** as follows.

Carrying amount of ROU asset after modification remeasurement <b>[a]</b>	\$29,043
Less: Carrying amount of ROU asset applying initial operating ROU asset measurement guidance to the modified lease (equal to the remeasured lease liability as there are no initial direct costs, lease incentives or other payments between LE and LR as a result of the modification) <b>[b]</b>	39,194
<b>[a] – [b]</b>	<b>\$(-10,151)</b>

LE calculates the remaining lease cost for the lease as follows.

Total remaining lease payments, reflecting the adjustment resulting from the lease term modification – i.e. all lease payments in Years 4–6	\$49,065
Less: Difference between <b>[a]</b> and <b>[b]</b> accounted for like a lease incentive	(10,151)
<b>Remaining cost of the lease</b>	<b>\$38,914</b>

Alternatively, LE may calculate the remaining lease cost as follows.

Total lease payments (including those paid and those not yet paid), reflecting the adjustment resulting from the lease term modification – i.e. all lease payments in Years 1–6	\$93,967
Plus: Total initial direct costs	5,000
Less: Periodic lease cost recognized in prior periods (sum of interest cost and ROU asset amortization in Years 1–3 in Example 6.4.10)	(60,053)
<b>Remaining cost of the lease</b>	<b>\$38,914</b>

LE recognizes a single lease cost, calculated so that the remaining cost of the lease is allocated over the remaining lease term on a straight-line basis – i.e. \$12,971 per year for the remaining three years.

LE accounts for the lease liability and the ROU asset from the effective date of the modification using the guidance in Topic 842 for an operating lease, as

illustrated below; LE uses Method 2 to subsequently measure the ROU asset (see paragraph 6.4.170).

Year	ROU asset amortization			ROU asset carrying amount			Lease liab. ending balance
	Straight-line lease cost	Lease liab. accret. <sup>1</sup>	ROU asset amort. <sup>2</sup>	Beg. balance	ROU asset amort.	End. balance	
4	\$12,971	\$(4,703)	\$8,268	\$29,043	\$ (8,268)	\$20,775	\$28,023
5	12,971	(3,363)	9,608	20,775	(9,608)	11,167	15,036
6	12,971	(1,804)	11,167	11,167	(11,167)	-	-

Notes:

1. Beginning lease liability balance (\$39,194 at the beginning of Year 4, \$28,023 at beginning of Year 5, \$15,036 at beginning of Year 6) × 12% discount rate for the modified lease.
2. Straight-line lease cost – Lease liability accretion.



### Question 6.7.10

#### Method of accounting for lease modifications that decrease the lessee's right(s) of use

#### Should a lessee apply a consistent method of remeasuring the ROU asset in lease modifications that decrease its right(s) of use?

**Background:** Example 18 in Subtopic 842-10 demonstrates two acceptable methods for calculating the change in the ROU asset resulting from a lease modification that decreases the lessee's rights to use one or more underlying assets. The first method measures the change in the ROU asset based on the change in the lease liability, while the second method measures that change based on how much of the original right of use remains after the modification. The two methods generally result in different outcomes. Example 6.7.30 also illustrates these two accounting methods.

**Interpretive response:** We believe a lessee's decision about the accounting method to apply to such modifications is an accounting policy election that should be applied consistently to similar lease modifications. The lessee's accounting policy should be disclosed if the effect of this decision is material to the lessee.



### Question 6.7.11

#### Acceptability of methods for remeasuring ROU asset in partial lease termination

##### Are both methods of remeasuring an ROU asset in a partial lease termination acceptable in all cases?

**Background:** Example 6.7.30 illustrates the two accounting methods for remeasuring a lessee's ROU asset as a result of a lease modification accounted for as a partial lease termination.

**Interpretive response:** No. We believe the first method illustrated in Example 6.7.30 (Scenario 1) is not appropriate if it results in no, or a disproportionate, decrease in the carrying amount of the ROU asset despite the full or partial termination. This is regardless of the lessee's accounting policy (see Question 6.7.10).

Applying the first method in these circumstances would lead to results that violate the principle that the ROU asset is to be reduced "on a basis proportionate to the full or partial termination of the existing lease." For example, this might occur if the termination is accompanied by a significant up-front payment, resulting in no or only an insignificant decrease to the lease liability. [842-10-25-13]

In contrast, we are unaware of any circumstances in which the second method illustrated in Example 6.7.30 (Scenario 2) would be inappropriate. Because the decrease in the remeasured ROU asset under that method is based directly on the decrease to the lessee's remaining right of use, its application is consistent with the ROU asset remeasurement principle.



### Question 6.7.15

#### Termination penalties in a partial termination scenario

##### Should a lessee recognize a termination penalty paid in connection with a partial lease termination up-front or over the lease term as part of lease expense?

**Background:** Example 6.7.30 illustrates a common scenario in which a lessor permits a lessee to terminate a portion of a lease, in return for a termination payment. In the example, Lessor LR permits Lessee LE to terminate its lease of 2,500 square feet out of a total leased office space of 10,000 square feet in return for a \$1,000 termination payment.

In these scenarios, the question arises about when, if ever, the lessee should recognize the termination payment up-front, or whether the lessee should recognize the termination payment over the remaining lease term of the non-terminated space (or assets) as part of the lease cost.

**Interpretive response:** Example 6.7.30 illustrates the termination payment in that partial termination modification scenario being recognized over the

remaining lease term of the non-terminated space, as part of the ongoing lease cost, rather than being recognized up-front.

We believe Topic 842 *requires* this accounting, and does not permit recognizing the termination payment up-front – e.g. as of the effective date of the modification or when the payment becomes legally owed. This is based on the following reasons. [842-10-25-11 – 25-13, 842-10-30-5(d), ASU 2016-02.BC173–BC174]

- Termination payments are explicitly included in the definition of ‘lease payments’ (see section 5.4.5), and the addition of a termination penalty to the contract in a contract modification changes the lease payments.
- The lessee modification model is generally a prospective model, with no profit or loss effect to the lessee at the time of the modification. The lessee accounts for the modified lease as if it is a new lease commencing on the effective date of the modification (see paragraphs 6.7.30 and 6.7.50). This means:
  - the lease liability is remeasured based on the remaining, unpaid ‘lease payments’ (including any unpaid termination penalty the lessee now owes), and the offsetting entry is to the remaining ROU asset; and
  - any lease payments (including the termination penalty) made before the effective date of the modification are lease prepayments, added to the remeasurement date ROU asset.

An exception arises, and a modification gain or loss recognized, *only* in a full or partial termination scenario, and in a partial termination scenario (such as Example 6.7.30) that gain or loss is calculated as the difference between (1) the proportional decrease in the lease liability and (2) the proportional decrease in the ROU asset.

### Change from Topic 840

The above represents a change from legacy US GAAP (Topic 840 and Topic 420 on exit or disposal costs). Under the prior guidance, which was changed by ASU 2016-02, a lessee may have concluded in some circumstances that either an explicit termination penalty or an increase in the rental payments over the remaining lease term should be recognized at the date of the lease modification. [840-20-55-4 – 55-6]



### Example 6.7.30 Partial lease termination

This example continues Examples 6.3.10 and 6.4.20, in which Lessee LE entered into a lease with Lessor LR to lease office space for a 10-year term. The terms and conditions are the same. Accordingly, the subsequent accounting for the lease in this example is the same as that illustrated in Example 6.4.20, absent lease reassessments or modifications. Also assume that the lease was for 10,000 square feet of space.

At the end of Year 6, LE and LR modify the lease for the remaining four years to reduce the lease to 7,500 square feet of the original space and to reduce the remaining annual lease payments by \$3,500 for each of the remaining four

years. In conjunction with the partial termination, LE also agrees to pay LR a termination fee of \$1,000.

At the end of Year 6 of the original lease (which is the effective date of the modification in this example), the carrying amount of the ROU asset and the lease liability were as follows (see Example 6.4.20):

Lease liability:	\$57,306
ROU asset:	\$53,350

Lease classification for the lease does not change as a result of the modification – i.e. it remains an operating lease because the modification reduces both the lease term and the lease payments.

LE remeasures the lease liability at the effective date of the modification based on a remaining lease term of four years, the remeasured lease payments (which decreased by \$3,500 per year as compared to the original terms of the lease), and LE's incremental borrowing rate at the modification date, which is 11%.

The lease payments for the modified contract are as follows (calculated based on the contractual annual lease payments from Example 6.3.10 starting in Year 7 – \$3,500 / year).

Yr 7	Yr 8	Yr 9	Yr 10	Total
\$13,846	\$14,366	\$14,902	\$15,454	<b>\$58,568</b>

The remeasured lease liability is \$46,210 (an \$11,096 or 19.36% decrease from the premodification liability).

### Scenario 1: Remeasuring the ROU asset based on the change in lease liability

#### *Modification accounting*

The decrease of 19.36% in the lease liability reflects the early termination of the right to use 2,500 square feet of space (or 25% of the original space), the change in the lease payments, and the change in the discount rate for the lease.

LE decreases the carrying amount of the ROU asset immediately before the modification (which equaled \$53,350) by 19.36% to reflect the partial termination of the lease. This results in a reduction in the ROU asset of \$10,329.

This results in the following journal entry related to the partial lease termination at the end of Year 6.

	Debit	Credit
Lease liability	11,096	
ROU asset		10,329
Gain on partial lease termination		767
<i>To recognize lease modification.</i>		

LE then records the following journal entry to account for the payment of the \$1,000 termination fee.

	<i>Debit</i>	<i>Credit</i>
Lease liability	1,000	
Cash		1,000
<i>To recognize termination payment as immediate reduction to lease liability.</i>		

### ***Post-modification accounting***

LE calculates the annual single lease cost to be recognized each year of the 4-year remaining lease term as follows.

Carrying amount of ROU asset after modification remeasurement <sup>1</sup>	\$43,021
Plus: Accretion to be recognized on the lease liability over the 4-year remaining lease term <sup>2</sup>	13,358
Remaining cost of the lease	56,379
Annual single lease cost (rounded) <sup>3</sup>	<b>\$14,095</b>
<b>Notes:</b>	
1. \$53,350 – \$10,329 = \$43,021.	
2. Remaining unpaid lease payments of \$59,568 – \$46,210 modified lease liability = \$13,358.	
3. Remaining cost of the lease / 4 years.	

From the effective date of the modification, the following table reflects LE's accounting for the modified lease throughout the remainder of the lease term.

Year	ROU asset carrying amount				Lease liability	Income statement		
	Beg. Balance	ROU asset amort.	Effect of mod.	End. balance		Carry. amt. (end. balance)	Accret.	ROU asset amort.
6	\$63,762	\$(10,412)	\$(10,329)	\$43,021	\$46,210	\$6,741	\$10,412	\$ 17,153
7	43,021	(9,122)	-	33,899	36,337	4,973	9,122	14,095
8	33,898	(10,098)	-	23,801	25,968	3,997	10,098	14,095
9	23,801	(11,238)	-	12,563	13,923	2,857	11,238	14,095
10	12,563	(12,563)	-	-	-	1,531	12,563	14,094
<b>Lease cost recognized during final 4 years:</b>							<b>\$ 56,379</b>	
<b>Lease cost recognized during entire 10-year lease term:</b>							<b>158,535</b>	
<b>Total cash payments during 10-year lease term:</b>							<b>158,535</b>	

**Scenario 2: Remeasuring the ROU asset based on the remaining right of use**

**Modification accounting**

LE determines the proportionate decrease in the carrying amount of the ROU asset based on the remaining ROU asset (7,500 square feet representing 75% of the original ROU asset).

Accordingly, LE decreases the carrying amount of the ROU asset by \$13,338 ( $25\% \times$  pre-modification ROU asset of \$53,350) and the carrying amount of the lease liability by \$14,327 ( $25\% \times$  pre-modification lease liability of \$57,306), which results in an adjusted lease liability balance of \$42,979. The following journal entry is recorded.

	<i>Debit</i>	<i>Credit</i>
Lease liability	14,327	
ROU asset		13,338
Gain on partial lease termination		989
<i>To recognize lease modification.</i>		

Next, LE records \$3,231 as an adjustment to the carrying amount of the ROU asset, reflecting the difference between the remaining lease liability of \$42,979 and the remeasured lease liability of \$46,210 (determined in the introduction to this example).

	<i>Debit</i>	<i>Credit</i>
ROU asset	3,231	
Lease liability		3,231

LE then records the following journal entry to account for the payment of the \$1,000 termination fee.

	<i>Debit</i>	<i>Credit</i>
Lease liability	1,000	
Cash		1,000
<i>To recognize termination payment as immediate reduction to lease liability.</i>		

**Post-modification accounting**

LE calculates the annual single lease cost to be recognized each year of the 4 year remaining lease term as follows.

Carrying amount of ROU asset after modification remeasurement <sup>1</sup>	\$43,243
Plus: Accretion to be recognized on the lease liability over the 4-year remaining lease term <sup>2</sup>	13,358
<b>Remaining cost of the lease</b>	<b>\$56,601</b>
Annual single lease cost (rounded) <sup>3</sup>	\$14,150

Notes:

1.  $\$53,350 - \$13,338 + \$3,231 = \$43,243$ .
2. Remaining unpaid lease payments of  $\$59,568 - 46,210$  modified lease liability =  $\$13,358$ .
3. Remaining cost of the lease / 4 years.

From the effective date of the modification, the following table reflects LE's accounting for the modified lease throughout the remainder of the lease term.

Year	ROU asset carrying amount				Lease liability	Income statement		
	Beg. Balance	ROU asset amort.	Effect of mod.	End. balance		Carry. amt. (end. balance)	ROU asset Accret.	amort.
6	\$63,762	\$(10,412)	\$(10,107)	\$43,243	\$46,210	\$6,741	\$10,412	\$ 17,153
7	43,243	(9,177)	-	34,066	36,337	4,973	9,177	14,150
8	34,066	(10,153)	-	23,913	25,968	3,997	10,153	14,150
9	23,913	(11,293)	-	12,620	13,923	2,857	11,293	14,150
10	12,620	(12,620)	-	-	-	1,531	12,620	14,151
<b>Lease cost recognized during final 4 years:</b>							<b>\$ 56,601</b>	
<b>Lease cost recognized during entire 10-year lease term:</b>							<b>158,535</b>	
<b>Total cash payments during 10-year lease term:</b>							<b>\$158,535</b>	



### Question 6.7.20

#### Modifications that both decrease the lessee's right(s) of use and extend the lease term

#### How should a lessee account for a modification that includes both a partial lease termination and a lease extension?

**Background:** For purposes of this Question, consider a scenario in which a lease modification decreases the lessee's right of use from 10,000 square feet of office space to 7,500 square feet, while also extending the lease term for the reduced 7,500 square feet of office space from 5 years to 10 years.

**Interpretive response:** It depends on whether the partial lease termination takes effect as of the 'effective date of the modification' (see paragraph 6.7.20) or later (e.g. one year after the effective date of the modification).

#### Partial lease termination takes effect as of the effective date of the modification

The lessee remeasures the lease liability for the partial lease termination before it remeasures the lease liability for the extended lease term. The partial lease termination is measured using the same approach applied to other partial lease terminations (see Question 6.7.10 and Example 6.7.30). The difference

between the reduction in the lease liability and the reduction in the ROU asset is recognized as a gain (loss) at the effective date of the modification.

When calculating the revised lease liability for the remainder of the *original* lease term, we believe the lessee should *not* update the discount rate for the lease; instead, it should continue using the discount rate in effect before the lease modification. Although Topic 842 does not have explicit guidance on whether to update the discount rate for the lease, the FASB and the IASB reached converged decisions on accounting for lessee lease modifications, and IFRS 16, Example 18 illustrates in a similar, two-step lease modification that the lessee should first remeasure the lease liability for the decrease in the scope of the lease using a non-updated discount rate. [IFRS 16.IE7]

After recognizing the effect of the partial termination, the lessee remeasures the lease liability and ROU asset for the extension of the lease term (see Example 6.7.20) based on the change in lease payments for the remainder of the revised lease term and an updated discount rate for the lease.

Example 6.7.35 illustrates this accounting.

### **Partial lease termination takes effect after the effective date of the modification**

At the effective date of the modification, the lessee first reevaluates the unit(s) of account for the lease. We believe the lessee's ability to terminate the lease for a portion of the underlying asset suggests that the right to use that portion of the underlying asset would have met the criteria to be a separate lease component; this is similar to when a lessee abandons or subleases a portion of an underlying asset for which its right to use was previously accounted for as a single unit of account (see section 6.5.2).

In the background example, the lessee would generally treat the modified contract as having two separate lease components: (1) one for 7,500 square feet of office space for which the lease term was extended, and (2) one for 2,500 square feet of office space for which the lease term was shortened (or not extended).

The lessee allocates the existing ROU asset and lease liability between the newly separate lease components on a relative stand-alone price basis. It then accounts for the modification of each component in the same manner it would for any other separate lease component – i.e. a lease term reduction of one separate lease component, and a lease term extension of the other. In some cases, the term of the first separate lease component may not be shortened; instead, it is merely not extended – i.e. it is permitted to expire at the end of the pre-modification lease term. In that case, there may be no additional accounting for that lease component after it is separated from the component being extended.

As discussed in Questions 6.5.80 and 6.5.90, Topic 842 does not address allocation between the newly separate lease components in this situation. Therefore, we believe a lessee could base the relative stand-alone price allocation on either:

- the stand-alone prices the lessee would have determined for the two separate lease components had they previously been accounted for separately (historical stand-alone prices); or

- the stand-alone prices of the two separate lease components at the effective date of the modification based on the remaining lease term and then-current facts and circumstances – e.g. current observable stand-alone prices (current stand-alone prices).



### Example 6.7.35

#### **Modification that both decreases the lessee's right of use (with immediate effect) and extends the lease term**

Lessee LE enters into a contract with Lessor LR for the right to use 10,000 square feet of office space for a 5-year term. The right to use the office space is a lease and there are no other components of the contract. LE classifies the lease as an operating lease because none of the tests for classification as a finance lease are met (see paragraph 6.2.50).

The following facts are also relevant at the commencement date.

Lease payments:	Fixed payments of \$100,000 per year in arrears, with a 3% increase every year after Year 1
Leased space (sq. ft.):	10,000
Renewal options:	None
Termination/purchase options:	None
LE's incremental borrowing rate:	5% (the rate implicit in the lease cannot be readily determined)
Initial direct costs (LE):	None

At the end of Year 2, LE and LR modify the lease to reduce the leased space from 10,000 square feet to 7,500 square feet, effective immediately. They also extend the term of the remaining, modified lease for the 7,500 square feet from 5 years (3 years remaining at the effective date of the modification) to 10 years (8 years remaining at the effective date of the modification).

Classification for the modified lease does not change – i.e. it remains an operating lease. The following facts are also relevant.

Lease payments:	Fixed payments of \$85,000 per year in arrears beginning with Year 3, with a 3% increase every year after Year 3
Leased space (sq. ft.):	7,500
Renewal options:	None
Termination/purchase options:	None
LE's incremental borrowing rate:	6% (the rate implicit in the lease cannot be readily determined)
Initial direct costs (LE):	None
Termination fee:	None

The lease payments under the modified contract are as follows.

	<b>Yr 3</b>	<b>Yr 4</b>	<b>Yr 5</b>	<b>Yr 6</b>	<b>Yr 7</b>	<b>Yr 8</b>	<b>Yr 9</b>	<b>Yr 10</b>	<b>Total</b>
	\$85,000	\$87,550	\$90,177	\$92,882	\$95,668	\$98,538	\$101,494	\$104,539	\$755,848

At the end of Year 2 of the original lease (i.e. the effective date of the modification), the carrying amount of the ROU asset and the lease liability are as follows.

ROU asset:	\$288,012
Lease liability:	\$297,377

### Step 1: Remeasure lease liability for partial termination

LE first remeasures the lease liability for the partial lease termination. Assume LE accounts for partial lease terminations using the approach illustrated in Scenario 1 of Example 6.7.30.

LE remeasures the lease liability for the partial lease termination based on:

- three years remaining of the original lease term;
- the reduced lease payments; and
- the original discount rate for the lease of 5%.

The remeasured lease liability is \$238,261 (i.e. the present value of the revised payments for Years 3–5 discounted at 5%), which is a \$59,116 (19.88%) decrease from the pre-modification lease liability.

LE correspondingly reduces the pre-modification carrying amount of the ROU asset by 19.88% (\$57,257).

LE records the following journal entry for Step 1.

	<i>Debit</i>	<i>Credit</i>
Lease liability	59,116	
ROU asset		57,257
Gain on partial lease termination		1,859
<i>To recognize partial lease termination.</i>		

### Step 2: Remeasure lease liability for extension of lease term

LE then remeasures the lease liability for the extended lease term based on:

- the eight-year remaining lease term post-modification;
- the remaining lease payments for Years 3–10; and
- the updated discount rate for the lease of 6%.

The remeasured lease liability equals \$581,436, which is an increase of \$343,175 from the \$238,261 calculated in Step 1.

LE records the following journal entry for Step 2.

	<i>Debit</i>	<i>Credit</i>
ROU asset	343,175	
Lease liability		343,175
<i>To recognize extension of lease term.</i>		

LE calculates the annual single lease cost to be recognized each year of the 8-year remaining lease term as follows.

Carrying amount of ROU asset after modification remeasurement <sup>1</sup>	\$573,930
Plus: Accretion to be recognized on the lease liability over the 8-year remaining lease term <sup>2</sup>	174,412
<b>Remaining cost of the lease</b>	<b>\$748,342</b>
Annual single lease cost (rounded) <sup>3</sup>	\$ 93,543
Notes:	
1. \$288,012 – 57,257 + 343,175 = \$573,930.	
2. Remaining unpaid lease payments of \$755,848 – \$581,436 modified lease liability = \$174,412.	
3. Remaining cost of the lease / 8 years.	

From the effective date of the modification, the following table reflects LE's accounting for the modified lease throughout the remainder of the lease term.

Yr.	ROU asset carrying amount				Lease liability	Income statement				
	Beg. balance	ROU asset amort.	Effect of mod. <sup>1</sup>	End. balance		Carry. amt. (end. balance)	Accret.	ROU asset amort.		
2	\$375,129	(\$87,117)	\$285,918	\$573,930	\$581,436	\$19,066	\$87,117	\$106,183		
3	573,930	(58,656)	-	515,274	531,322	34,887	58,656	93,543		
4	515,274	(61,664)	-	453,610	475,652	31,879	61,664	93,543		
5	453,610	(65,004)	-	388,606	414,014	28,539	65,004	93,543		
6	388,606	(68,702)	-	319,904	345,973	24,841	68,702	93,543		
7	319,904	(72,785)	-	247,119	271,064	20,758	72,785	93,543		
8	247,119	(77,279)	-	169,840	188,789	16,264	77,279	93,543		
9	169,840	(82,215)	-	87,625	98,622	11,327	82,215	93,542		
10	87,625	(87,625)	-	-	-	5,917	87,625	93,542		
<b>Lease cost recognized over remaining 8-year lease term:</b>							<b>\$748,342</b>			
<b>Lease cost recognized over entire 10-year lease term:</b>							<b>958,848</b>			
<b>Total lease payments over 10-year lease term:</b>							<b>958,848</b>			
Note:										
1. \$343,175 (Step 2 addition) – \$57,257 (Step 1 reduction) = \$285,918.										



### Example 6.7.36

#### **Modification that both decreases the lessee's right of use (with delayed effect) and extends the lease term**

Assume the same facts as in Example 6.7.35, except that the partial lease termination takes effect one year after the effective date of the modification (i.e. at the end of Year 3). Correspondingly, the lease payments are reduced to \$85,000 beginning in Year 4 and increase by 3% every year thereafter.

The lease payments for the modified contract are as follows (the payment for Year 3 is unchanged from the pre-modified contract).

Yr 3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8	Yr 9	Yr 10	Total
\$106,090	\$85,000	\$87,550	\$90,177	\$92,882	\$95,688	\$98,538	\$101,494	<b>\$757,399</b>

#### **Step 1: Reevaluate the unit(s) of account**

LE reevaluates the unit(s) of account, and concludes that the right to use the to-be-terminated portion of the underlying asset qualifies as a separate lease component.

Therefore, LE separates the original lease component into two components:

- **Component 1:** 7,500 square feet of space for which the lease term has been extended by five years, and therefore has a remaining lease term of 8 years as of the effective date of the modification
- **Component 2:** 2,500 square feet of space for which the lease term has been reduced by two years, and therefore has a remaining lease term of only 1 year as of the effective date of the modification.

#### **Step 2: Allocate between the two units of account**

LE allocates the pre-modification lease liability and ROU asset as of the end of Year 2 between the two components on a relative stand-alone price basis. In this example, LE has elected to use historical stand-alone prices in similar scenarios (see Question 6.7.20).

Component	Stand-alone price <sup>1</sup>	Allocation	Lease liability	ROU asset
Component 1	\$420,000	75%	\$223,033	\$216,009
Component 2	140,000	25%	74,344	72,003
<b>Total</b>	<b>\$560,000</b>	<b>100%</b>	<b>\$297,377</b>	<b>\$288,012</b>

Note:

1. Because LE is using historical rather than current stand-alone prices, those prices are based on two five-year leases. LE determines that the historical stand-alone prices in this case are proportional to the size of the space that comprises each component; that may not be the case in other circumstances.

LE then allocates the remaining lease payments until the partial lease termination takes effect between Component 1 and Component 2 using the

same 75/25 allocation, and the lease payments for the remaining lease term after Component 2 expires 100% to Component 1. Therefore, the remaining lease payments are allocated to Component 1 and Component 2 as follows.

Year	Component 1	Component 2	Total
3	\$ 79,568	\$26,522	\$106,090
4	85,000	-	85,000
5	87,550	-	87,550
6	90,177	-	90,177
7	92,882	-	92,882
8	95,668	-	95,668
9	98,538	-	98,538
10	101,494	-	101,494
<b>Total</b>	<b>\$730,877</b>	<b>\$26,522</b>	<b>\$757,399</b>

### Step 3: Account for the modifications of each component

#### Component 1: Extended lease term

LE remeasures the lease liability for Component 1 based on:

- the eight-year remaining lease term post-modification;
- the remaining lease payments allocable to Component 1 for Years 3–10; and
- an updated discount rate for the lease of 6%.

The remeasured lease liability equals \$561,712, which is an increase of \$338,679 from the \$223,033 calculated in Step 2.

LE records the following journal entry.

	Debit	Credit
ROU asset	338,679	
Lease liability		338,679
<i>To remeasure lease liability of Component 1 for extended lease term; corresponding adjustment to ROU asset.</i>		

LE concludes that the modified Component 1 lease is an operating lease. Therefore, LE calculates the annual single lease cost to be recognized each year of the 8-year remaining lease term as follows.

Carrying amount of ROU asset after modification remeasurement <sup>1</sup>	\$554,688
Plus: Accretion to be recognized on the lease liability over the 8-year remaining lease term <sup>2</sup>	169,165
<b>Remaining cost of the lease</b>	<b>\$723,853</b>
Annual single lease cost (rounded) <sup>3</sup>	\$ 90,482

## Notes:

1.  $\$216,009 + 338,679 = \$554,688$ .
2. Remaining unpaid lease payments of  $\$730,877 - \$561,712$  modified lease liability =  $\$169,165$ .
3. Remaining cost of the lease / 8 years.

From the effective date of the modification, the following table reflects LE's accounting for the modified Component 1 throughout the remainder of the lease term.

Yr.	ROU asset carrying amount				Lease liability	Income statement		
	Beg. balance	ROU asset amort.	Effect of mod.	End. balance		Carry. amt. (end. balance)	Accret.	ROU asset amort.
2	\$281,347	(\$65,338)	\$338,679	\$554,688	\$561,712	\$14,299	\$65,338	\$79,637
3	554,688	(56,779)	-	497,909	515,847	33,703	56,779	90,482
4	497,909	(59,531)	-	438,378	461,798	30,951	59,531	90,482
5	438,378	(62,774)	-	375,604	401,956	27,708	62,774	90,482
6	375,604	(66,364)	-	309,240	335,897	24,118	66,364	90,482
7	309,240	(70,328)	-	238,912	263,168	20,153	70,328	90,481
8	238,912	(74,691)	-	164,221	183,290	15,790	74,691	90,481
9	164,221	(79,484)	-	84,737	95,749	10,997	79,484	90,481
10	84,737	(84,737)	-	-	-	5,745	84,737	90,482

**Component 2: Reduced lease term**

LE remeasures the lease liability for Component 2 based on:

- the one-year remaining lease term post-modification;
- the remaining lease payments allocable to Component 1 for Year 3; and
- an updated discount rate for the lease of 3%.

The remeasured lease liability equals \$25,750, which is a decrease of \$48,594 from the \$74,344 calculated in Step 2.

LE records the following journal entry.

	Debit	Credit
Lease liability	48,594	
ROU asset		48,594
<i>To remeasure lease liability of Component 2 for reduced lease term; corresponding adjustment to ROU asset.</i>		

LE concludes that the modified Component 1 lease is an operating lease. Therefore, LE calculates the single lease cost to be recognized in Year 3 as follows.

Carrying amount of ROU asset after modification remeasurement <sup>1</sup>	\$23,409
Plus: Accretion to be recognized on the lease liability over the one-year remaining lease term <sup>2</sup>	772
Remaining cost of the lease	<b>\$24,181</b>
Notes:	
1. \$72,003 – 48,594 = \$23,409. 2. Remaining unpaid lease payments of \$26,522 – \$25,750 modified lease liability = \$772.	

From the effective date of the modification, the following table reflects LE's accounting for the modified component throughout the remaining lease term.

Yr.	ROU asset carrying amount				Lease liability	Income statement		
	Beg. balance	ROU asset amort.	Effect of mod.	End. balance		Carry. amt. (end. balance)	Accret.	ROU asset amort.
2	\$93,782	\$(21,779)	\$(48,594)	\$23,409	\$25,750	\$4,766	\$21,779	\$26,545
3	23,409	(23,409)	-	-	-	772	23,409	24,181

### Question 6.7.25

#### Continued right of use after effective date of modification

**Is a lease modification that does not terminate the lessee's right of use immediately and completely a lease term reduction or a lease termination?**

**Background:** Assume Lessee LE and Lessor LR have an existing, ten-year lease of office space. At the end of Year 5 of the lease, LE and LR agree to early terminate the lease. LE must vacate the leased office space within two weeks; LE retains exclusive use of the space during that period. LE will pay LR a one-time termination fee.

As of the end of Year 5, which is the 'effective date of the modification' (see paragraph 6.7.20), LE has already relocated most of its personnel and office equipment from the office space. During the two-week continued use period, LE will relocate the few remaining employees and office equipment to another office space in the same geographic area.

In scenarios like this one, the question arises about whether the contract modification is:

- a lease termination, which would result in the immediate (1) derecognition of the entire ROU asset and lease liability, and (2) recognition of the termination fee on the effective date of the modification (see section 6.8); or
- a lease term reduction, which means (1) the ROU asset and lease liability will be remeasured, but not derecognized entirely, at the effective date of the modification, and (2) the termination fee will be treated as a component of the lease cost to be recognized over the two-week remaining lease term (see Question 6.7.15).

**Interpretive response:** Assuming a lease still exists for the short remaining period, a lease modification that permits the lessee to continue to use the underlying asset after the effective date of the modification is a lease term reduction, *not* a lease termination. Note: lease identification is reassessed on contract modification (see paragraph 3.1.20).

This is regardless of whether the lessee's right of use is for only a very short period of time and for a limited purpose as compared to the lessee's original right of use, such as short-term storage. Topic 842 does not treat lease term reduction modifications differently based on either (1) the duration of the remaining lease term (post-reduction) or (2) any new restrictions placed on the lessee (e.g. with respect to permitted uses of the underlying asset).

In the background scenario, this means LE will account for the modification as a lease term reduction, and not a lease termination.

#### Accounting before the effective date of the modification

Before the modification date, the lessee may commit to a plan to abandon the ROU asset. Section 6.5.2 has guidance on determining if that is the case and, if so, the accounting that should result.



**Question 6.7.30**

**Terminating one lease and entering into another with the same lessor**

#### How does a lessee account for the contemporaneous termination of one lease and inception of another with the same lessor?

**Background:** A common example of lessee substitution with the same lessor is a lessee moving from one retail space in a shopping center to another in the same shopping center or another lessor-owned shopping center nearby – e.g. to accommodate the need for more or less space or for one with a different layout.

When this occurs, whether enacted through a contract amendment or by terminating the existing contract and entering into a new one, questions arise about how to account for the modification and in particular how to account for any difference between the carrying amounts of the original ROU asset and the related lease liability at the termination date. In a straightforward termination scenario – i.e. the lessee does not exchange its right to use the original

underlying asset for the right to use another underlying asset of the lessor – that difference is recognized in profit or loss (see section 6.8). [842-20-40-1]

**Interpretive response:** The unit of lease accounting under Topic 842 is the separate lease component (see section 4.1). Therefore, we believe the lessee must both: [842-10-15-28; 842-20-25-1, 40-1]

- derecognize the ROU asset and lease liability for the original lease component on the date the original lease is terminated; and
- recognize the ROU asset and lease liability for the new lease component when that lease commences.

However, the agreement to terminate the original lease component and enter into the new lease component are contemporaneous and part of a single commercial negotiation. Therefore, regardless of whether these two actions are papered as a single contract amendment or separately, they constitute a single transaction based on the Topic 842 contract combination guidance (see section 4.6). [842-10-25-19]

The resulting accounting depends on whether the ‘effective date of the modification’ (see paragraph 6.7.20) precedes the termination date of the original lease.

#### Original lease is terminated on the effective date of the modification

We believe any gain or loss from derecognizing the original lease component (i.e. the difference between the carrying amounts of the ROU asset and the lease liability) should be adjusted for any off-market terms of the new lease component. This approach reflects the economic interrelationship of the two actions.

The lessee calculates whether the pricing for the new lease component is off-market by comparing the present value of the lease payments to market rental payments. The new lease component is not off-market solely because the payments for the lease include a significant variable component.

In determining whether the new lease component is off-market, the calculation should be performed in the same way as for a sale-leaseback transaction (see section 9.2). The lessee should consider variable payments that it reasonably expects to make on the basis of all reasonably available information (e.g. historical, current and/or forecasted), as well as the basis on which those variable payments are determined (e.g. the sales- or usage-based royalty rate).

- If the new lease component is priced **below market**, the difference between (1) the present value of the lease payments (including expected variable payments) and (2) the present value of the market rental payments (also including expected variable payments) *increases the gain or reduces the loss* recognized on the termination of the original lease component. The offset is recognized as a lease prepayment.
- If the new lease component is priced **above market**, the difference between (1) the present value of the lease payments (including expected variable payments) and (2) the present value of the market rental payments (also including expected variable payments) *reduces the gain or increases the loss* recognized on the termination of the original lease component. The offset is recognized as a lease incentive.

If the new lease component has not commenced at the effective date of the modification, the lessee accounts for the lease prepayment or lease incentive in the same manner as it would any other lease payment made or lease incentive earned before commencement of the related lease (see Question 6.3.15 for lease incentives earned pre-commencement). If the new lease component has commenced, the prepayment or incentive affects the initial measurement of the new lease component ROU asset as outlined in paragraph 6.3.70.

#### **Effective date of the modification precedes original lease termination**

The effective date of the modification may frequently precede both the termination of the original lease component and the commencement of the new lease component. In that case, there are two elements to the lease modification:

- the lease term reduction of the original lease component – i.e. the lease term is reduced to the period from the effective date of the modification to the date it will be terminated; and
- the addition of the new lease component.

Consistent with any other lease modification, the lessee must remeasure and reallocate the ‘consideration in the contract’ to the remaining lease and non-lease components of the contract (if any) at the effective date of the modification using then-current stand-alone prices (see paragraph 6.7.50). At the effective date of the modification, and ignoring any non-lease components, the modified contract contains two separate lease components: (1) the shortened original lease component and (2) the new lease component.

Because these two lease components will be recognized based on current stand-alone prices, no off-market adjustment to any gain that results from remeasuring the original lease liability (i.e. because adjusting the ROU asset by the same amount would reduce its carrying amount below zero) at the effective date of the modification is necessary. [842-20-35-4]

Because the modification is accounted for ahead of the original lease termination, the ROU asset and lease liability should both have carrying amounts of zero at the termination date. Therefore, there should not be any gain or loss at the termination date.



#### Question 6.7.40

#### **Lessor payment for terminating one lease and entering into another**

#### **How does a lessee account for a payment from a lessor to early terminate one lease and enter into another?**

**Background:** Consider the same scenarios described in Question 6.7.30. In addition, the lessor makes a payment to the lessee for agreeing to terminate the original lease and enter into a new lease for a different underlying asset.

**Interpretive response:** Considering the accounting framework in Question 6.7.30, we believe that:

- If the original lease is terminated on the effective date of the modification, the lessor payment should be treated as a lease incentive of the new lease. As such, it will affect the analysis in Question 6.7.30 about whether the new lease component is priced at market. For example, if the new lease component would have been at market without the lessor payment, it will be priced below market with the payment factored in. Question 6.7.30 outlines the effects of above- or below-market pricing for the new lease component. [842-10-30-5(a), 55-30(a)]
- If the original lease will be terminated after the effective date of the modification, the lessor payment is part of the remeasured 'consideration in the contract' (i.e. reducing it) that gets allocated to the remaining lease and non-lease components of the contract (see paragraph 6.7.50).



### Example 6.7.40

#### Master lease agreement

Lessee LE is a manufacturer of protective packaging and requires extrusion equipment for use in its production process. LE is expanding its business to a new location and needs to equip its new manufacturing facility with extrusion equipment for its production lines. LE wants to ramp up its production capacity by beginning with 20 new production lines immediately and expanding once sales demand is established.

LE enters into a master lease agreement with Lessor LR to lease up to 50 extrusion machines for a fixed monthly payment amount of \$2,000 per machine for a total term of seven years from delivery of the first machine (at the beginning of Year 1). The monthly per machine payment does not change depending on how many machines are delivered to LE. LE is required to take delivery of 20 machines immediately and to take delivery of a minimum of 10 additional machines from LR by the end of Year 2. There are no residual value guarantees and the lease payments cannot change (e.g. based on an index or rate) during the seven-year term unless the contract is modified.

When LE takes delivery of any of the 10 mandated additional machines, no lease modification is deemed to occur. However, if LE takes delivery of more than 30 machines in total, a lease modification will be deemed to occur when each drawdown from the master lease above the guaranteed minimum of 30 occurs.

Even if LE draws down only the required minimum of 30, while there would be no lease modification resulting from drawing down 10 additional machines after taking delivery of the first 20 machines, some measurement and allocation complexities could arise if there were, for example, residual value guarantees or if the monthly lease payments escalated during the lease term based on an index or rate (e.g. CPI). Question 4.3.40 discusses these considerations in further detail.



## Comparison to legacy US GAAP

### Modification guidance is substantially changed from Topic 840

6.7.80 The lease modification guidance in Topic 842 is substantially different from, and more extensive than, the guidance on lease modifications in Topic 840. There is virtually no parallel between the two sets of guidance such that entities should take careful note of the new modifications guidance and not assume that anything done with respect to modifications under Topic 840 applies under Topic 842.

## 6.8 Lease terminations



### Excerpt from ASC 842-20

#### 40 Derecognition

##### General

> Lease Termination

**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.

• > Purchase of the Underlying Asset

**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.

6.8.10 A termination penalty paid or received upon termination that was not already included in the lease payments is generally included in the gain or loss on termination. [842-10-30-5(d), 842-20-40-1]

6.8.20 If a lease is terminated because the underlying asset is purchased by the lessee before the end of the lease term, the lessee recognizes an adjustment to the carrying amount of the asset purchased as follows. [842-20-40-2]



6.8.30 The provisions of paragraph 6.8.20 do not apply to situations where the underlying asset is acquired by the lessee in a business combination (see section 11.1). [842-20-40-2]



### Example 6.8.10

#### Full lease termination

##### Scenario 1: Termination of lease before expiration of lease term

Lessee LE entered into a lease with Lessor LR to lease a building for a 15-year term. At the commencement date of the lease, LE appropriately classified the lease as an operating lease. There were no impairments, remeasurements or modifications during the first 10 years of the lease term. There are no other existing business relationships between LE and LR.

At the end of Year 10, LE and LR agree to terminate the lease. There was no termination option in the lease agreement. In conjunction with the termination, LE also agrees to pay LR a termination fee of \$5,000, which was not previously included in the lease payments. At the date of termination, LE has the following balances for the operating lease recognized on its balance sheet.

Lease liability:	\$104,405
ROU asset:	\$101,520

LE records the following journal entry for the lease termination at the end of Year 10 to derecognize the lease liability and the ROU asset, recognize the termination penalty and record the resulting loss in its income statement.

	Debit	Credit
Lease liability	104,405	
Loss on lease termination	2,115	
ROU asset		101,520
Cash		5,000
<i>To recognize lease termination and penalty paid.</i>		

##### Scenario 2: Lessee purchases asset during the lease term

Assume the same facts as Scenario 1, except that at the end of Year 10 LE agrees to purchase the building from LR for \$110,000. There is no lease termination penalty, and the purchase by LE does not result from a purchase option that LE was reasonably certain to exercise.

LE determines the adjustment to record to the carrying amount of the purchased asset as follows.

Purchase price paid	\$ 110,000
Less: Carrying amount of lease liability immediately before purchase	(104,405)
<b>Adjustment to carrying amount of asset</b>	<b>\$ 5,595</b>

LE records the following journal entry to recognize the termination of the lease and purchase of the underlying asset at the end of Year 10.

	Debit	Credit
Lease liability	104,405	
PP&E – building <sup>1</sup>	107,115	
ROU asset		101,520
Cash		110,000
<i>To recognize lease termination and purchase of asset.</i>		
Note:		
1. \$101,520 ROU asset + \$5,595 adjustment = \$107,115.		



### Question 6.8.10

#### Lessee recognition of lease cancellation payment premium

#### Should a lessee recognize a lease cancellation payment from the lessor in income immediately?

**Background:** Consider a scenario in which Lessee LE is leasing a building from Lessor LR under a long-term lease. LE decides that it no longer needs the use of the building, and LE and LR agree to cancel the lease. However, because fair market rent for the building has increased since the original execution of the lease, LR pays a premium to LE in return for LE agreeing to cancel the lease.

**Interpretive response:** It depends. If the lessee has no remaining obligation to the lessor or the new lessee, the payment is recognized by the lessee in income when it becomes receivable. However, if there is any remaining lease obligation on the part of the lessee (e.g. because the cancellation does not take effect immediately), the payment from the lessor should be treated in the same manner as a lease incentive (see section 5.4.3).

Additionally, the lessee needs to consider whether there is any ongoing vendor or customer relationship with the lessor.

- If the lessee has an ongoing customer relationship with the lessor, it considers the guidance in Topic 705 (cost of sales and services).
- If the lessee is a vendor to the lessor, it considers the guidance in Topic 606 with respect to accounting for consideration received (or receivable) from a customer; see chapter 3 of KPMG Handbook, [Revenue recognition](#).

## 6.8A Lease accounting – lessee in bankruptcy

6.8A.10 Guidance on lessee accounting for leases upon entering, and while in, bankruptcy is included in section 4.7 of KPMG Handbook, [Accounting for bankruptcies](#).

## 6.9 Presentation (Step 9)



### Excerpt from ASC 842-20

#### 45 Other Presentation Matters

##### General

> Statement of Financial Position

**45-1** A **lessee** shall either present in the statement of financial position or disclose in the notes all of the following:

- a. **Finance lease right-of-use assets** and **operating lease** right-of-use assets separately from each other and from other assets
- b. Finance **lease liabilities** and operating lease liabilities separately from each other and from other liabilities.

Right-of-use assets and lease liabilities shall be subject to the same considerations as other nonfinancial assets and financial liabilities in classifying them as current and noncurrent in classified statements of financial position.

**45-2** If a lessee does not present finance lease and operating lease right-of-use assets and lease liabilities separately in the statement of financial position, the lessee shall disclose which line items in the statement of financial position include those right-of-use assets and lease liabilities.

**45-3** In the statement of financial position, a lessee is prohibited from presenting both of the following:

- a. Finance lease right-of-use assets in the same line item as operating lease right-of-use assets
- b. Finance lease liabilities in the same line item as operating lease liabilities.

> Statement of Comprehensive Income

**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.

## &gt; Statement of Cash Flows

**45-5** In the statement of cash flows, a **lessee** shall classify all of the following:

- Repayments of the principal portion of the **lease liability** arising from **finance leases** within financing activities
- Interest on the lease liability arising from finance leases in accordance with the requirements relating to interest paid in Topic 230 on cash flows
- 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
- Variable lease payments** and **short-term lease** payments not included in the lease liability within operating activities.

6.9.10 The following chart summarizes the financial statement presentation requirements applicable to lessees, which are specified in detail in paragraphs 6.9.20 – 6.9.130. [842-20-45-1 – 45-5]

	Balance sheet	Income statement	Statement of cash flows
Finance leases	<p><b>ROU assets</b></p> <ul style="list-style-type: none"> <li>— Separate line item; or</li> <li>— Within another line item, separate from where operating lease ROU assets are presented</li> </ul> <p><b>Lease liabilities</b></p> <ul style="list-style-type: none"> <li>— Separate line item; or</li> <li>— Within another line item, separate from where operating lease liabilities are presented</li> </ul>	<p><b>ROU asset amortization</b></p> <ul style="list-style-type: none"> <li>— Consistent with presentation of depreciation or amortization of similar assets</li> </ul> <p><b>Interest expense on lease liability</b></p> <ul style="list-style-type: none"> <li>— Consistent with presentation of other interest expense</li> </ul>	<p><b>Principal repayments</b></p> <ul style="list-style-type: none"> <li>— Financing activities</li> </ul> <p><b>Interest payments</b></p> <ul style="list-style-type: none"> <li>— In accordance with Topic 230 (typically in operating activities)</li> </ul> <p><b>Variable lease payments</b></p> <ul style="list-style-type: none"> <li>— Operating activities</li> </ul>
Operating leases	<p><b>ROU assets</b></p> <ul style="list-style-type: none"> <li>— Separate line item; or</li> <li>— Within another line item, separate from where finance lease ROU assets are presented</li> </ul> <p><b>Lease liabilities</b></p> <ul style="list-style-type: none"> <li>— Separate line item; or</li> <li>— Within another line item, separate from where finance lease liabilities are presented</li> </ul>	<p><b>Lease expense</b></p> <ul style="list-style-type: none"> <li>— Included in lessee's income from continuing operations (operating expense)</li> </ul>	<p><b>Lease payments</b></p> <ul style="list-style-type: none"> <li>— Operating activities, unless payments are for costs to put another asset in service</li> </ul> <p><b>Variable lease payments</b></p> <ul style="list-style-type: none"> <li>— Operating activities</li> </ul>

## 6.9.1 Balance sheet

6.9.20 A lessee presents on the balance sheet (or discloses in the notes) the following. [842-20-45-1]

- Finance lease ROU assets and operating lease ROU assets separately from each other and from other assets.
- Finance lease liabilities and operating lease liabilities separately from each other and from other liabilities.

6.9.30 If a lessee does not present finance lease and operating lease ROU assets and lease liabilities separately on the balance sheet, it discloses the line items in which the ROU assets and lease liabilities are included. [842-20-45-2]

6.9.40 ROU assets and lease liabilities are classified as current or noncurrent on a classified balance sheet in the same manner as any other nonfinancial assets and financial liabilities. [842-20-45-1]



**Question 6.9.10**  
**Classification of ROU assets and lease liabilities**

### Are ROU assets and lease liabilities classified in current and noncurrent portions on the lessee's balance sheet?

**Interpretive response:** For ROU assets, no. Consistent with the treatment of property, plant and equipment and intangible assets, ROU assets are not classified into current and noncurrent portions. In contrast, lease liabilities are classified into current and noncurrent portions (consistent with other financial liabilities).

We believe either of the following approaches may be acceptable under Topic 210 (balance sheet) to determine the current portion of the lease liability.

- **Approach 1.** The current portion of the lease liability is the amount by which the total lease liability will be reduced over the next 12 months (or operating cycle, if longer). This equals the payment(s) the lessee will make, less interest/accretion of the lease liability.
- **Approach 2.** The current portion of the lease liability is equal to the present value of the lease payment(s) scheduled to be made over the next 12 months (or operating cycle, if longer).

Under both approaches, the noncurrent portion of the lease liability is calculated as the difference between the carrying amount of the total lease liability and the current portion.



## Example 6.9.10

### Classification of lease liabilities

Lessee LE enters into a lease of equipment from Lessor LR. The lease commences on January 1, 20X1, has a lease term of four years and annual payments of \$100 due in arrears on December 31 of each year.

After the initial payment on December 31, 20X1, LE calculates its remaining lease liability at December 31, 20X1, 20X2 and 20X3, using its incremental borrowing rate at lease commencement of 6% as follows.

	20X1	20X2	20X3
Total lease liability	\$ 267	\$ 183	\$ 94

Under Topic 210, LE classifies liabilities as current when they are expected to be repaid within 12 months.

#### Scenario 1: LE applies Approach 1

Under Approach 1 in Question 6.9.10, the current portion of the lease liability at the end of 20X1 is \$84. This amount represents the portion of the 20X2 annual payment of \$100 that will reduce the total lease liability from the end of 20X1 to the end of 20X2. \$84 is calculated as the end of 20X2 payment of \$100, reduced by the \$16 of expected 20X2 interest (if a finance lease) / accretion (if an operating lease) on the lease liability.

The following table illustrates the calculation of the current and noncurrent lease liability for each year of the lease term.

Period	Beg. balance A	Interest / accretion B <sup>1</sup>	Lease payment C	Ending balance D = A - C+B	Current lease liability E <sup>2</sup>	Noncurr. lease liability D-E
20X1	\$346	\$21	\$100	\$267	\$84	\$183
20X2	267	16	100	183	89	94
20X3	183	11	100	94	94	0
20X4	94	6	100	0	-	-

Notes:

1. Calculated as the beginning balance (A) × 6%.
2. Calculated as the annual lease payment for the next year – interest/accretion for the upcoming 12 months (e.g. for end of 20X1, \$100 20X2 payment – \$16 20X2 interest/accretion = \$84).

#### Scenario 2: LE applies Approach 2

Under Approach 2 in Question 6.9.10, the current portion of the lease liability at the end of 20X1 is \$94. This amount represents the end of 20X1 present value of the \$100 20X2 payment that will be made at the end of 20X2, discounted at 6%.

The following table illustrates the calculation of the current and noncurrent lease liability for each lease period.

Period	Beg. balance A	Interest / accretion B <sup>1</sup>	Lease payment C	Ending balance D = A - C+B	Current lease liability E <sup>2</sup>	Noncurr. lease liability D-E
20X1	\$346	\$21	\$100	\$267	\$94	\$173
20X2	267	16	100	183	94	89
20X3	183	11	100	94	94	0
20X4	94	6	100	0	-	-

Notes:

1. Calculated as the beginning balance (A)  $\times$  6%.
2. Calculated as the present value of the annual lease payment for the next year (\$100 each year for this lease), discounted at 6%.

6.9.50 A lessee is prohibited from presenting: [IAS 16]

- finance lease ROU assets in the same balance sheet line item as operating lease ROU assets; and
- finance lease liabilities in the same balance sheet line item as operating lease liabilities.

6.9.60 Operating lease liabilities are presented and accounted for (e.g. when considering such amounts in Topic 360 impairment testing – see section 6.5) as operating liabilities, rather than as debt. Therefore, when considering how to present these liabilities on the balance sheet, entities might consider a presentation similar to what they do for other discounted financial liabilities that are considered operating in nature, such as restructuring liabilities and asset retirement obligations. [IAS 16-2.BC14, BC264]

### Question 6.9.15\*\*

**Change in approach used to determine classification of lease liabilities**

**Is a change in the approach used to determine the current portion of lease liabilities considered a change in accounting principle?**

**Interpretive response:** Yes. As outlined in Question 3.2.40 of KPMG Handbook, [Accounting changes and error corrections](#), Topic 250 does not provide specific guidance on changes in classification and presentation and, in general, we do not believe such changes rise to the level of a change in accounting principle.

However, we believe a change to the approach used to determine the current portion of lease liabilities (see Question 6.9.10) is a change in accounting principle because the change affects the *measurement* of two balance sheet line items (i.e. the line item that includes the current portion of the entity's

operating or finance lease liabilities, and the line item that includes the noncurrent portion).

See section 3.3 of KPMG Handbook, [Accounting changes and error corrections](#), on assessing, accounting for and disclosing changes in accounting principles.



### Observation

#### **Lessee balance sheet presentation focused on user needs**

6.9.70 The balance sheet presentation requirements outlined in paragraphs 6.9.20 – 6.9.40 are about ensuring that financial statement users get the benefit of what the Board believes is the primary improvement to US GAAP resulting from Topic 842: the recognition of ROU assets and lease liabilities for all leases other than short-term leases. The Board wanted users to be able to identify the amounts and where they are included on the balance sheet. [\[ASU 2016-02.BC262\]](#)

6.9.80 The requirement not to include finance lease ROU assets and lease liabilities in the same balance sheet line items as their operating lease counterparts (see paragraph 6.9.50) is primarily a function of the Board's view that finance leases and operating leases are two different types of transactions – one being more similar to a purchase of the underlying asset; the other being simply a rental of another entity's owned asset. Therefore, in their view, presenting the assets and liabilities that result from these two different types of transactions in the same line item on the balance sheet would be misleading. [\[ASU 2016-02.BC263-BC264\]](#)

6.9.90 The Board concluded that operating lease liabilities, while financial, should be characterized as operating liabilities principally because such liabilities are not debt-like in nature – e.g. the treatment of operating lease obligations in bankruptcy is generally different from the treatment of finance lease obligations. [\[ASU 2016-02.BC264\]](#)

## 6.9.2 Income statement

6.9.100 For finance leases, a lessee presents the interest expense on the lease liability and the amortization of the ROU asset in a manner consistent with how the entity presents other interest expense and depreciation or amortization of similar assets, respectively. They are not required to be presented as separate line items. [\[842-20-45-4\(a\)\]](#)

6.9.110 For operating leases, a lessee presents lease expense in income from continuing operations. [\[842-20-45-4\(b\)\]](#)



### Question 6.9.20

#### Presentation of variable lease payments

### Should variable lease expense be recognized as an operating expense in the income statement of the lessee?

**Interpretive response:** For operating leases, yes.

Topic 842 does not address this explicitly for finance leases. However, the basis for conclusions to ASU 2016-02 states, “variable lease payments not included in lease liabilities should be classified within operating activities in the statement of cash flows because the corresponding lease cost will be presented in income from continuing operations.” Therefore, we believe it would be acceptable to present variable lease expense as an operating expense within income from continuing operations. [\[ASU 2016-02.BC271\]](#)

However, because (1) the basis for conclusions is not authoritative and (2) the Board has asserted that the new leases guidance was not intended to substantially change lessees’ income statements, which may present variable lease expense resulting from capital leases as additional interest expense on the capital lease obligation under Topic 840, we believe it is also acceptable for a lessee to present variable lease expense resulting from a finance lease as interest expense.



### Question 6.9.30

#### Presentation of operating lease cost after an impairment or planned abandonment of the ROU asset

### How should a lessee present operating lease cost after the ROU asset has been impaired or scheduled for abandonment?

**Interpretive response:** In general, absent other concurrent events or changes in circumstances – e.g. a conclusion that the ROU asset is part of a disposal group that meets the requirements of a discontinued operation under Subtopic 205-20 (discontinued operations) – an impairment or planned abandonment should not change how a lessee presents operating lease cost in the income statement.

#### Impairment

Paragraphs 6.5.10 and 6.5.50 highlight the following.

- The impairment loss related to an ROU asset (operating or finance) is presented in the same manner in the income statement as an impairment loss recognized for any other long-lived asset.
- After an operating lease ROU asset has been impaired, a single lease cost continues to be recognized, comprising amortization of the ROU asset, if any, and lease liability accretion.

We believe the post-impairment single lease cost continues to be presented in the income statement consistent with how it was presented pre-impairment – i.e. within the same line item. This includes if the single lease cost does not include any ROU asset amortization – e.g. the ROU asset was impaired to \$0.

### Planned abandonment

Question 6.5.70 outlines that if a lessee plans to abandon an ROU asset:

- amortization should be accelerated, using one of two acceptable approaches, to ensure the ROU asset is amortized to its salvage value by the cease-use date; and
- after the ‘decision date’ (see paragraph 6.5.160), a single lease cost continues to be recognized, comprising (1) the accelerated amortization of the ROU asset and lease liability accretion before the cease-use date (see paragraph 6.5.160) or (2) solely the lease liability accretion after the cease-use date (if the salvage value of the ROU asset was \$0 at the cease-use date).

Consistent with our view on impairment, we believe the single lease cost after the decision date should be presented in the income statement consistent with how it was presented before the decision date – i.e. within the same line item. This includes for the period after the cease-use date when the single lease cost may comprise solely lease liability accretion.



### Question 6.9.40

#### Presentation of lease termination or remeasurement gain when the ROU asset was previously impaired or abandoned

#### How should a lessee present a gain from terminating or remeasuring a lease that results from the ROU asset being impaired or abandoned?

**Background:** Assume an ROU asset has been impaired or abandoned such that on terminating the lease or remeasuring the lease liability downward (e.g. for a reduced lease term) a significant gain results. A gain results because recording the decrease in the lease liability as an adjustment to the ROU asset would result in a negative ROU asset, which is prohibited (see paragraph 6.6.170).

While a gain may be more pronounced in an impairment or abandonment scenario, one could arise in other circumstances – e.g. if significant lease incentives paid early during the lease result in the ROU asset having a lower carrying amount than the lease liability.

In these scenarios, the question arises about the income statement presentation of the gain.

**Interpretive response:** Other than when the gain results from a previous ROU asset impairment, we believe the lessee should present the gain in the same income statement line item in which it presented the single lease cost for an

operating lease or the ROU asset amortization for a finance lease, as a reduction of the previous lease cost/amortization recognized.

If the gain results from a prior ROU asset impairment, we believe it should be presented in the same line item in which the impairment was previously recognized up to the amount of the previously recognized impairment; the remainder of the gain should be recognized consistent with the preceding paragraph. However, we believe presenting the entire gain consistent with the preceding paragraph is also acceptable.

### 6.9.3 Statement of cash flows

6.9.120 A lessee classifies cash flows from leasing transactions as follows. [842-20-45-5, 230-10-45-25(e)]

Statement of cash flows	
Finance lease	
Repayment of principal portion of lease liability	Financing activities
Interest on the lease liability	Apply Topic 230 (statement of cash flows) <sup>1</sup>
Variable lease payments and short-term lease payments not included in the lease liability	Operating activities <sup>2</sup>
Operating lease	
Lease payments	Operating activities <sup>2</sup>
Variable lease payments and short-term lease payments not included in the lease liability	Operating activities <sup>2</sup>
Notes:	
1. Typically operating activities. 2. Included in investing activities to the extent the payments represent costs to bring another asset to the condition and location necessary for its intended use.	

6.9.130 The initial recognition of a lease liability and ROU asset is a noncash transaction that is not included in the statement of cash flows but separately disclosed with other noncash transactions. [842-20-50-4(g)(2)]

6.9.140 Chapter 14 of KPMG Handbook, [Statement of cash flows](#), provides further guidance on lease reporting in the statement of cash flows.

# 7. Lessor accounting

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New item added in this edition: \*\*

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## How the standard works

A lessor classifies a lease as a (1) sales-type, (2) direct financing or (3) operating lease using criteria described in section 7.2. The accounting model applied to each type of lease depends on the lease classification and is summarized in the following diagram.

	Balance sheet	Income statement	Cash flow statement
Sales-type and direct financing leases	<ul style="list-style-type: none"> <li>— Recognize net investment in the lease</li> <li>— Derecognize the underlying asset</li> </ul>	<ul style="list-style-type: none"> <li>— Selling profit (loss)<sup>1</sup></li> <li>— Interest income over the lease term</li> </ul>	<p>Cash received from leases classified as operating cash flows<sup>2</sup></p>
Operating leases	<p>Continue to recognize the underlying asset</p>	<p>Lease income generally on a straight-line basis over the lease term</p>	<p>Cash received from leases classified as operating cash flows</p>

### Notes:

1. Selling profit is recognized at lease commencement for sales-type leases and over the lease term for direct financing leases. Selling loss is recognized at lease commencement for both sales-type and direct financing leases.
2. Lessors that are depository or lending institutions in the scope of Topic 942 (depository and lending institutions) classify the principal portion of cash payments received from leases as investing cash flows; the interest portion is classified as operating cash flows.

## 7.1 Overview



### Excerpt from ASC 842-30

#### 05 Overview and Background

##### General

**05-1** This Subtopic addresses accounting by **lessors** for **leases** that have been classified as **sales-type leases**, **direct financing leases**, or **operating leases** in accordance with the requirements in Subtopic 842-10. Lessors should follow the requirements in this Subtopic as well as those in Subtopic 842-10.

#### 15 Scope and Scope Exceptions

##### General

**15-1** This Subtopic follows the same Scope and Scope Exceptions as outlined in the Overall Subtopic; see Section 842-10-15.

7.1.10 The following table shows the key concepts and definitions underlying the lessor accounting model.

Key concept or definition	Meaning in Topic 842
<b>Net investment in the lease</b>	Lease receivable + unguaranteed residual asset <sup>1</sup>
<b>Lease receivable</b>	PV of the lease payments + PV of guaranteed portion of estimated residual value
<b>Unguaranteed residual asset</b>	PV of unguaranteed portion of estimated residual value
<b>Commencement date</b> (see section 5.1)	Date on which the lessor makes the underlying asset available for use by the lessee; date of initial recognition and measurement of a lease
<b>Lease term</b> (see section 5.3)	Non-cancellable period of the lease + periods covered by lessee option to extend that lessee is reasonably certain to exercise + periods subsequent to lessee termination option that lessee is reasonably certain not to exercise + periods covered by a lessor-controlled option to extend or not to terminate
<b>Lease payments</b> (see section 5.4)	Undiscounted fixed (including in-substance fixed) payments + optional payments that are reasonably certain to be paid
<b>Discount rate for the lease</b> (see section 5.6)	Rate implicit in the lease

Key concept or definition	Meaning in Topic 842
<b>Rate implicit in the lease</b> (see section 5.6.1)	Discount rate that balances the following equation: PV of lease payments + PV of estimated residual value = Fair value of the underlying asset + deferred initial direct costs

Note:

- For a direct financing lease, the amount of the net investment in the lease is reduced by any selling profit on the lease because it is deferred.

### Observation **Lessor accounting largely consistent with Topic 840**

7.1.20 Topic 842 did not make extensive changes to lessor accounting. However, despite the overall similarities between the lessor accounting guidance in Topic 842 as compared with Topic 840, the Board made certain changes for one or more of the following reasons: [\[ASU 2016-02.BC90-BC92\]](#)

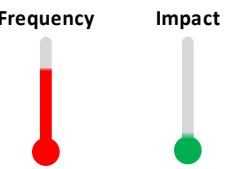
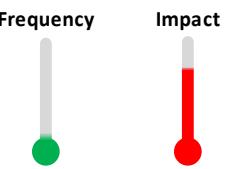
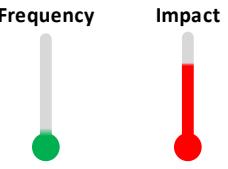
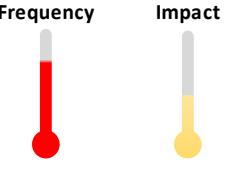
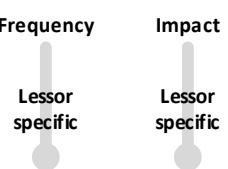
- to align the lessor accounting guidance with changes to the lessee accounting guidance;
- to align the lessor accounting guidance with certain aspects of Topic 606; and/or
- to improve and/or simplify lessor accounting to remediate a long-standing complexity or absence of guidance under Topic 840.

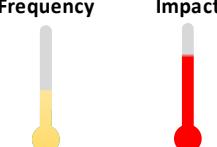
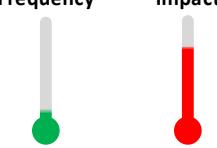
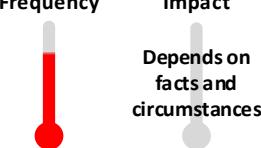
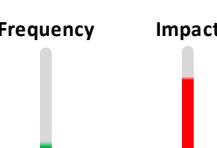
### Comparison to legacy US GAAP

#### **Key changes to lessor accounting**

7.1.30 Although the lessor accounting model under Topic 842 is not fundamentally changed from the lessor accounting model under Topic 840, there are important changes that will affect many lessors.

7.1.40 The following chart summarizes the key changes Topic 842 makes to the Topic 840 lessor accounting model. Each change illustrated in the chart includes our current general expectation about the frequency with which that change will arise and the impact we expect the change to have when it does. The actual frequency and impact will vary by lessor. For some of the changes, the frequency of occurrence and/or impact of the change is so specific to the facts and circumstances that no general expectation is provided.

Key change	Summary
<b>Changes in lease classification between sales-type and direct financing</b> (see section 7.2)  	<p>Sales-type leases and direct financing leases are no longer differentiated by whether there is manufacturer/dealer profit or loss. Instead, they are differentiated by whether the lessor effectively transfers control of the underlying asset to the lessee or, instead, transfers substantially all of the risks and benefits of ownership of the underlying asset to the lessee and an unrelated third party.</p> <ul style="list-style-type: none"> <li>— The changes will result in many direct financing leases under Topic 840 being classified as sales-type leases under Topic 842.</li> <li>— A smaller number of sales-type leases under Topic 840 will be classified as direct financing leases under Topic 842.</li> </ul>
<b>Recognition of selling profit</b> (see section 7.3.1) 	<p>If selling profit arises from a direct financing lease, it is deferred and recognized over the lease term.</p> <p>This is not expected to occur frequently because selling profit only arises infrequently in a lease that will be classified as a direct financing lease under Topic 842. However, because such leases would have been sales-type leases under Topic 840, the effect of deferring selling profit that was previously recognized up-front may be significant.</p>
<b>Narrowed definition of initial direct costs</b> (see section 5.5) 	<p>Under Topic 842, initial direct costs include only those incremental costs of a lease that would not have been incurred if the lease had not been executed. Therefore, some costs (e.g. legal fees and allocated internal costs) that an entity capitalized as initial direct costs under Topic 840 will be expensed as incurred under Topic 842. For some lessors, this will result in recognizing more expenses before the lease commences and higher margins on lease income earned over the lease term.</p>
<b>Allocation of consideration in the contract to lease and non-lease (e.g. service) components</b> (see section 4.4) 	<p>Under Topic 842, lessors apply the transaction price allocation guidance in Topic 606, while under Topic 840, lessors applied the relative stand-alone selling price approach prescribed by Subtopic 605-25 (revenue recognition – multiple-element arrangements). The allocation approach under Topic 606 differs from Subtopic 605-25 in some respects, particularly the specific guidance in Topic 606 on allocating bundled discounts and variable consideration that did not exist under Subtopic 605-25.</p>

Key change	Summary
<b>Executory costs</b> (see section 4.2) 	<p>Under Topic 842, lessee payments of lessor executory costs (e.g. lessor property tax or insurance costs) are allocated to the lease and non-lease components in the same manner as all other payments in the contract; they are not excluded from lease classification and certain other aspects of lease accounting as they were under Topic 840.</p> <ul style="list-style-type: none"> <li>— Section 4.2.1 and the Gross vs. net considerations in section 7.3.2 provide guidance on determining whether taxes and insurance are lessee or lessor costs.</li> <li>— Section 4.2 explains that maintenance, which was considered an executory cost under Topic 840, is a non-lease component.</li> </ul>
<b>Collectibility</b> (see section 7.5) 	<p>Under Topic 842, leases with collectibility uncertainties are no longer precluded from sales-type lease classification as they were under Topic 840. Topic 842 includes specific guidance about lease income recognition when collectibility of the lease payments, plus any amounts necessary to satisfy residual value guarantees, is not probable.</p>
<b>Lease modifications</b> (see section 7.6) 	<p>Topic 842 includes guidance on lease modifications that is substantially different from Topic 840; it was developed to more closely align lessor modification accounting with the contract modification accounting applicable to sellers of goods or services in Topic 606.</p> <p>Lease classification is reassessed on a lease modification that is not accounted for as a separate contract. The lessor accounting for a lease modification depends on the classification of the original and the modified lease.</p>
<b>Leveraged leases</b> (see section 7.8) 	<p>Leveraged lease classification and accounting is eliminated by Topic 842 for all leases that commence on or after the effective date of Topic 842.</p> <p>Lessors continue to account for leveraged leases that commenced before the effective date in accordance with Topic 840, unless the lease is modified on or after the effective date (which includes exercise of a renewal that was not already factored into the lease term).</p>

## 7.2 Lease classification



### Excerpt from ASC 842-10

#### 25 Recognition

##### General

> Lease Classification

**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).

**25-2** A lessee shall classify a lease as a **finance lease** and a **lessor** shall classify a lease as a **sales-type lease** when the lease meets any of the following criteria at lease commencement:

- a. The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
- b. The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
- c. The lease term is for the major part of the remaining economic life of the underlying asset. However, if the commencement date falls at or near the end of the economic life of the underlying asset, this criterion shall not be used for purposes of classifying the lease.
- d. The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments in accordance with paragraph 842-10-30-5(f) equals or exceeds substantially all of the fair value of the underlying asset.
- e. The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

**25-3** When none of the criteria in paragraph 842-10-25-2 are met: ...

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

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

**25-3A** Notwithstanding the requirements in paragraphs 842-10-25-2 through 25-3, a lessor shall classify a lease with **variable lease payments** that do not depend on an index or a rate as an operating lease at lease commencement if classifying the lease as a sales-type lease or a direct financing lease would result in the recognition of a **selling loss**.

**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.

**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).

## 55 Implementation Guidance and Illustrations

• • > Effect of Investment Tax Credits

**55-8** When evaluating the **lease** classification criteria in paragraphs 842-10-25-2(d) and 842-10-25-3(b)(1), the **fair value** of the **underlying asset** should be reduced by any related investment tax credit retained by the **lessor** and expected to be realized by the lessor.

• • > Residual Value Guarantees for a Portfolio of Underlying Assets

**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).



## Excerpt from ASC 842-30

### 55 Implementation Guidance and Illustrations

#### General

> Implementation Guidance

- > Sales of Equipment with Guaranteed Minimum Resale Amount

**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.

• > Fair Value of the Underlying Asset

**55-17A** Notwithstanding the definition of **fair value**, if a lessor is not a manufacturer or a dealer, the fair value of the **underlying asset** at lease commencement is 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 underlying asset and lease commencement, the definition of fair value shall be applied.

7.2.10 A lessor determines lease classification for each separate lease component, which is the unit of account in applying Topic 842 (see section 4.1), at the lease commencement date. [842-10-25-1]

7.2.20 Lease classification is only reassessed if the lease is modified and the modification is not accounted for as a separate contract (see section 7.6). [842-10-25-1]

7.2.30 For the lease classification test, a lessor applies a 'Step 0' test before it proceeds to the Part A and B tests. [842-10-25-2 – 25-3A]

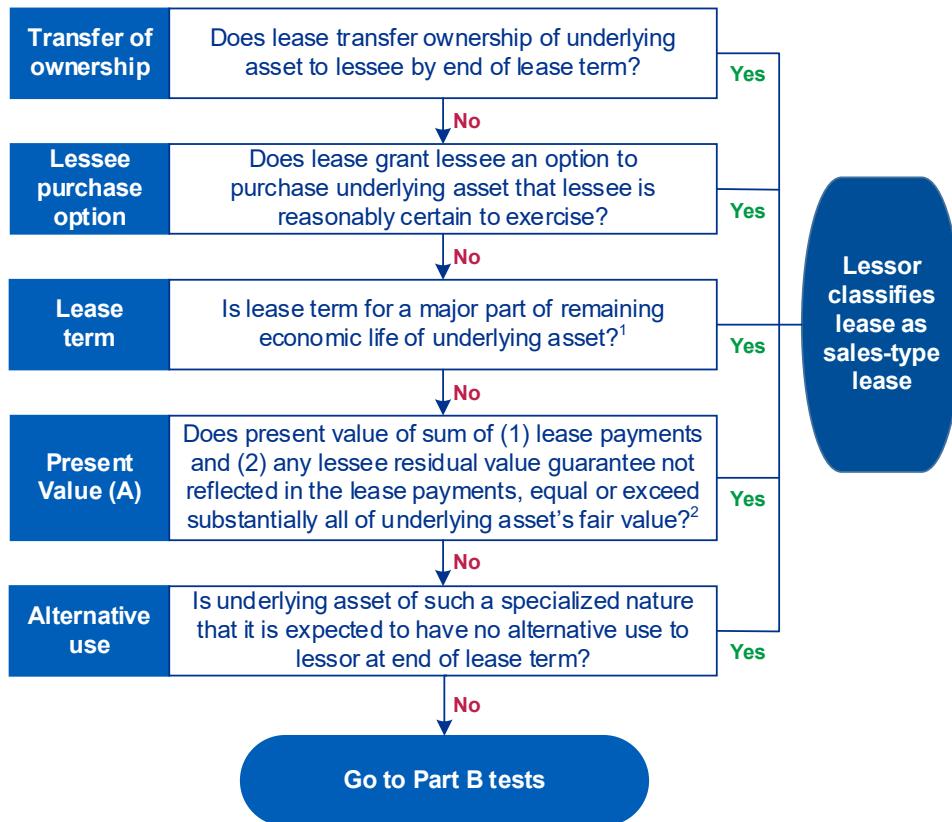
— **Step 0.** A lessor is required to classify a lease as operating if:

- the payments for the lease are partially or entirely variable; and
- sales-type or direct financing classification would result in a commencement date ('Day 1') loss.

If only one or neither of these criteria are met, the lessor proceeds to the Part A tests.

— **Part A.** These tests determine whether a lease is a sales-type lease and are the same as the classification tests for lessees. The outcome of these tests is either (1) the lease is a sales-type lease, or (2) further testing is required (Part B) to classify the lease.

— **Part B.** These tests determine whether the lease is an operating lease or a direct financing lease.

**Part A tests:**

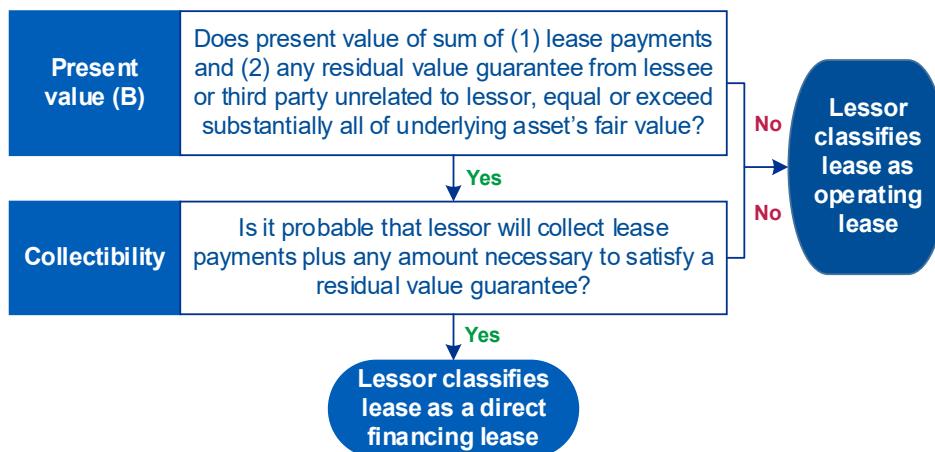
## Notes:

1. If the commencement date is at or near the end of the underlying asset's economic life, this test does not apply. See Questions 6.2.10 and 6.2.15 in section 6.2.
2. How to determine the fair value of the underlying asset differs depending on whether the lessor is a manufacturer or dealer (see paragraph 7.3.41).

7.2.40 Because the Part A lease classification tests are the same for lessors as they are for lessees, our discussion of the application of those tests is mostly in section 6.2.

7.2.50 However, there are two additional points relevant to lessors in applying the Part A classification tests. [842-10-25-4]

- The lessor determines the present value of the lease payments and residual value guarantees using the rate implicit in the lease (see section 5.6.1) – i.e. unlike lessees, a lessor always uses the rate implicit in the lease.
- For purposes of determining whether a lease is a sales-type lease, a lessor assumes that no initial direct costs will be deferred when calculating the rate implicit in the lease if, and only if, at the commencement date the fair value of the underlying asset is different from its carrying amount.

**Part B tests:**

7.2.60 The Part B classification tests focus on whether substantially all of the lessor's risk in the lease is credit risk. When the lessor effectively converts its risk in the nonfinancial residual asset to credit risk (e.g. through a residual value guarantee provided by an unrelated third party) and collectibility of the lease payments (plus any amount necessary to satisfy the residual value guarantee(s) provided to the lessor) is probable, the lease is a direct financing lease. Otherwise, it is an operating lease.

7.2.70 The primary difference between the present value test in Part A and the present value test in Part B is the inclusion in Part B of a residual value guarantee provided by a third party unrelated to the lessee or the lessor (in addition to any residual value guarantee provided by the lessee in the Part A present value test). Consistent with the present value test in Part A, a lessor may use a threshold of 90 percent or more when determining whether the sum of the present value of (1) the lease payments and (2) any residual value guarantees amount to 'substantially all' of the fair value of the underlying asset. Section 6.2 provides additional discussion about substantially all. [842-10-25-2 – 25-4]

7.2.80 Additionally, in determining the rate implicit in the lease for purposes of the Part B present value test, the lessor always assumes any initial direct costs will be deferred when calculating the rate implicit in the lease; this is regardless of whether the fair value of the underlying asset is different from its carrying amount. As a result, the rate implicit in the lease used for purposes of performing the present value test may be different in the Part A and Part B tests. [842 Glossary, 842-10-25-4]

7.2.90 Residual value guarantees of a portfolio of underlying assets generally preclude a lessor from determining the amount of the guaranteed residual value of any individual underlying asset within the portfolio. Consequently, such amounts are usually ignored when performing the present value lease classification test, whether Part A or Part B. [842-10-55-10]



### Question 7.2.05

#### **Lessor consideration of portfolio residual value guarantees in lease classification**

##### **When is it acceptable for a lessor to consider a portfolio residual value guarantee when performing the present value lease classification test?**

**Background:** Paragraph 842-10-55-10 was included in Topic 842 with the intent to retain guidance similar to the SEC guidance that was codified in Topic 840. [840-30-S99-1]

In practice under Topic 840 (including when considering the SEC staff's view in paragraph 840-30-S99-1) there were *limited* conditions under which it was considered acceptable for a lessor to include portfolio residual value guarantees in the 'minimum lease payments' used to perform the present value lease classification test. Those conditions were:

- the leases have the same commencement and ending dates;
- the underlying assets are interchangeable (i.e. essentially the same); and
- there is a high correlation in the variability of the expected residual values of the leased assets.

**Interpretive response:** Because the guidance in paragraph 842-10-55-10 was intended to preserve the accounting that occurred under Topic 840, we believe it remains acceptable under Topic 842 for a lessor to consider a portfolio residual value guarantee in performing the present value lease classification test when the conditions outlined in the background are met.

See Question 6.2.25 for consideration of portfolio residual value guarantees for lessees under Topic 842.



### Question 7.2.06

#### **Portfolio residual value guarantee guidance applicability**

##### **Does the portfolio residual value guarantee guidance apply to a portfolio of only two, non-homogenous underlying assets?**

**Background:** See paragraph 7.2.90 and Question 7.2.05.

**Interpretive response:** Yes, we believe the portfolio residual value guarantee guidance referred to in the background applies even when the 'portfolio' comprises only two, non-homogenous underlying assets such as land and a building.

First, as outlined in Question 7.2.05, we believe homogeneity within the portfolio makes it *more* likely to be acceptable to consider a portfolio residual value guarantee when performing the present value lease classification test.

Second, 'portfolio' is not a defined term in Topic 842; therefore, there is nothing to suggest that a portfolio must comprise more than two underlying assets for the portfolio residual value guarantee guidance to apply.



### Question 7.2.10

#### Seller guarantee of resale amount – transfer of control

**Does a seller guarantee of any deficiency between the purchaser's resale proceeds from the asset and a guaranteed resale amount mean the purchaser does not obtain control of the asset?**

**Background:** Under Topic 840, a seller guarantee of this nature resulted in accounting for the arrangement as a lease. The FASB and IASB discussed whether this type of guarantee precludes transfer of control of the asset to the purchaser at the January 2013 joint Board meeting and included discussion in the Basis for Conclusions to ASU 2014-09.

**Interpretive response:** It depends. If a purchaser would otherwise obtain control of an asset absent the seller resale guarantee, the terms of the guarantee will affect whether it precludes the purchaser from obtaining control of the asset.

ASU 2014-09 states 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." That could be read to suggest that the Boards believe a seller resale guarantee *cannot* affect the transfer of control conclusion. However, at the January 2013 FASB/IASB Board meeting at which the FASB and IASB reached this conclusion, the FASB and IASB staffs explained that the seller resale guarantee is substantively just a seller residual value guarantee. The staffs explained that "when an entity guarantees the residual value, the customer is not encumbered in its ability to utilize the asset or enjoy substantially all the remaining benefits from the asset ... in these cases the customer could choose to keep the asset, thus maintaining legal title and physical possession, or should the customer decide to sell the asset, the customer would be entitled to any sales proceeds in excess of the guaranteed amount if they were able to sell the asset for a higher amount." [ASU 2014-09.BC431, IASB Agenda Paper 7B/FASB Agenda Paper 166B]

Therefore, while this suggests that the Board generally does not believe a seller resale guarantee would prevent the purchaser from obtaining control of the asset, there is language in the staff agenda paper that suggests a seller resale guarantee *could* prevent a purchaser from obtaining control of the asset depending on the terms of the resale guarantee. For example, the staff guidance refers to the purchaser's unencumbered ability to utilize the asset and retain any resale proceeds in excess of the guaranteed amount. Therefore, if the terms of the arrangement were such that the purchaser was *required* to sell the asset after a specified period of time and the seller was entitled to any resale proceeds that exceed the guaranteed resale amount, we believe the

purchaser typically would be constrained in its ability to direct the use of the asset and obtain substantially all of its remaining benefits (thus, would not obtain control of the asset).

If there is a sale of the asset (i.e. control of the asset transfers to the customer) in accordance with Topic 606, the seller accounts for the guaranteed resale amount provision in accordance with Topic 460 (guarantees). [842-30-55-4]

If a seller resale guarantee precludes the purchaser from obtaining control of the asset, it is accounted for as a lease in accordance with Topic 842.



### Question 7.2.20

#### Lease classification in a lease resulting from a repurchase agreement

#### Can a lease arising as a result of a repurchase agreement be classified as a sales-type lease?

**Background:** In a sale transaction, the customer does not obtain control of the asset being sold if the seller has a forward or a call option or the customer has a put option that it has a 'significant economic incentive' to exercise. In those cases, if the repurchase price is less than the original sales price, the seller accounts for the contract as a lease; see chapter 7 of KPMG Handbook, *Revenue recognition*. [606-10-55-68, 55-72]

**Interpretive response:** Yes. The guidance in Topic 606 merely states that the contract should be accounted for as a lease. Therefore, if the lease meets one of the criteria to be classified as a sales-type lease (e.g. the length of the repurchase agreement, which would represent the lease term, is for a major part of the asset's remaining economic life), the seller (lessor) will account for the lease as such (see section 7.3).

This means despite Topic 606 stating that, as a result of the repurchase agreement, the customer does not obtain control of the asset (i.e. no sale occurs), the seller (lessor) will still (1) derecognize the underlying asset and (2) recognize selling profit.



#### Comparison to legacy US GAAP

##### Lease classification

7.2.100 In general, the lease classification guidance in Topic 842 results in operating lease classification for most leases that were classified as operating leases under Topic 840.

7.2.110 The following tables summarize the key differences in lease classification for lessors under Topic 840 and Topic 842.

Topic 840	Topic 842
<b>Sales-type lease</b>	
<p>Resulted when the lease met:</p> <ul style="list-style-type: none"> <li>— any of the criteria in paragraph 840-10-25-1;</li> <li>— both of the criteria in paragraph 840-10-25-42; and</li> <li>— the fair value of the underlying asset did not equal its carrying amount.</li> </ul>	<p>Results when the lease passes <b>Step 0</b> and then passes any of the five <b>Part A</b> tests in paragraph 7.2.30.</p>
<b>Impact</b>	
<p>Many leases that were classified as direct financing leases under Topic 840 will be classified as sales-type leases under Topic 842; however, the accounting effect of that difference in classification will typically be insignificant.</p> <p>In contrast, relatively few leases that were classified as sales-type leases under Topic 840 will be classified as direct financing leases under Topic 842; but the accounting effect will be significant for those leases, because the selling profit, which was recognized at lease commencement under Topic 840, will be deferred and recognized over the lease term instead under Topic 842 (see section 7.3).</p>	

Topic 840	Topic 842
<b>Direct financing lease</b>	
<p>Resulted when the lease met:</p> <ul style="list-style-type: none"> <li>— any of the criteria in paragraph 840-10-25-1;</li> <li>— both of the criteria in paragraph 840-10-25-42; and</li> <li>— the fair value of the underlying asset equals its carrying amount.</li> </ul>	<p>Results when the lease:</p> <ul style="list-style-type: none"> <li>— passes <b>Step 0</b>;</li> <li>— passes none of the <b>Part A</b> tests; but</li> <li>— passes both <b>Part B</b> tests.</li> </ul>
<b>Impact</b>	
<p>The same as discussed for sales-type leases.</p>	

Topic 840	Topic 842
<b>Leveraged leases</b>	
<p>Resulted when the lease met:</p> <ul style="list-style-type: none"> <li>— the criteria to be classified as a direct financing lease; and</li> <li>— three additional specified criteria in paragraph 840-10-25-43(c).</li> </ul>	<p>Leveraged lease classification and accounting no longer exists prospectively from the effective date of Topic 842 (see section 13.6).</p>
<b>Impact</b>	
<p>Leases that commence on or after the effective date of Topic 842 that would have been classified as leveraged leases under Topic 840 will be accounted for differently under Topic 842. In addition, any grandfathered leveraged leases that are modified on or after the effective date are no longer accounted for as leveraged leases after the modification under Topic 842.</p>	

Topic 840	Topic 842
<b>Real estate leases</b>	
Real estate leases were subject to classification requirements different from other leases. For example, a real estate lease could only be a sales-type lease if ownership was transferred to the lessee.	Real estate leases no longer have special rules; they are subject to the same guidance as all other leases.
<b>Impact</b>	
Lease classification for real estate leases under Topic 842 will differ more significantly from Topic 840 than for other leases. More real estate leases will be classified as sales-type or direct financing leases under Topic 842.	

Topic 840	Topic 842
<b>Collectibility uncertainties</b>	
If collectibility of the minimum lease payments was not reasonably predictable, the lease was classified as an operating lease. An exception existed when the underlying asset was real estate and ownership transferred to the lessee.	Collectibility uncertainties do not preclude a lease from being classified as a sales-type lease. However, a lease cannot be classified as a direct financing lease if the collectibility test is failed (see flowchart in paragraph 7.2.50).
<b>Impact</b>	
Some leases previously classified as operating leases because of collectibility uncertainties under Topic 840 will be classified as sales-type leases under Topic 842. For a discussion of collectibility considerations for lessors, see section 7.5.	

Topic 840	Topic 842
<b>Unreimbursable costs</b>	
If there were important uncertainties as to the amount of unreimbursable costs that the lessor would incur under the lease, the lease was classified as an operating lease. For example, a commitment by the lessor to guarantee the performance of the underlying asset that was more extensive than a typical product warranty or to effectively protect the lessee from obsolescence of the underlying asset resulted in operating lease classification. An exception existed when the underlying asset was real estate and ownership transferred to the lessee.	There is no similar lease classification test in Topic 842.
<b>Impact</b>	
Some leases previously classified as operating leases under Topic 840 because of failing to meet this criterion will be classified as sales-type or direct financing leases under Topic 842.	

## 7.3 Sales-type and direct financing leases

### 7.3.1 Initial recognition and measurements



#### Excerpt from ASC 842-30

##### 25 Recognition

###### General

> Sales-Type Leases

**25-1** At the **commencement date**, a **lessor** shall recognize each of the following and derecognize the **underlying asset** in accordance with paragraph 842-30-40-1:

- a. A **net investment in the lease**, measured in accordance with paragraph 842-30-30-1
- b. Selling profit or selling loss arising from the lease
- c. **Initial direct costs** as an expense if, at the commencement date, the **fair value** of the underlying asset is different from its carrying amount. If the fair value of the underlying asset equals its carrying amount, initial direct costs (see paragraphs 842-10-30-9 through 30-10) are deferred at the commencement date and included in the measurement of the net investment in the lease. The **rate implicit in the lease** is defined in such a way that those initial direct costs eligible for deferral are included automatically in the net investment in the lease; there is no need to add them separately.

> Direct Financing Leases

**25-7** At the **commencement date**, a **lessor** shall recognize both of the following and derecognize the **underlying asset** in accordance with paragraph 842-30-40-1:

- a. A **net investment in the lease**, measured in accordance with paragraph 842-30-30-2
- b. Selling loss arising from the **lease**, if applicable.

**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 Initial Measurement

###### General

> Sales-Type and Direct Financing Leases

**30-1** At the **commencement date**, for a **sales-type lease**, a **lessor** shall measure the **net investment in the lease** to include both of the following:

- a. The **lease receivable**, which is measured at the present value, discounted using the **rate implicit in the lease**, of:
  - 1. The **lease payments** (as described in paragraph 842-10-30-5) not yet received by the lessor
  - 2. The amount the lessor expects to derive from the **underlying asset** following the end of the **lease term** that is guaranteed by the **lessee** or any other third party unrelated to the lessor
- b. The **unguaranteed residual asset** at the present value of the amount the lessor expects to derive from the underlying asset following the end of the lease term that is not guaranteed by the lessee or any other third party unrelated to the lessor, discounted using the rate implicit in the lease.

**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.

**30-3** See Example 1 (paragraphs 842-30-55-18 through 55-43) for an illustration of the requirements for sales-type and direct financing leases.

## 40 Derecognition

### General

> Sales-Type and Direct Financing Leases

**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).

## 55 Implementation Guidance and Illustrations

### General

> Implementation Guidance

• > Fair Value of the Underlying Asset

**55-17A** Notwithstanding the definition of **fair value**, if a lessor is not a manufacturer or a dealer, the fair value of the **underlying asset** at lease commencement is 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 underlying asset and lease commencement, the definition of fair value shall be applied.

> Illustrations

• > 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).

**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.

*[The remainder of Example 1 Case A is not included in this section because it is not relevant – it is included in section 7.3.2]*

••• > 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.

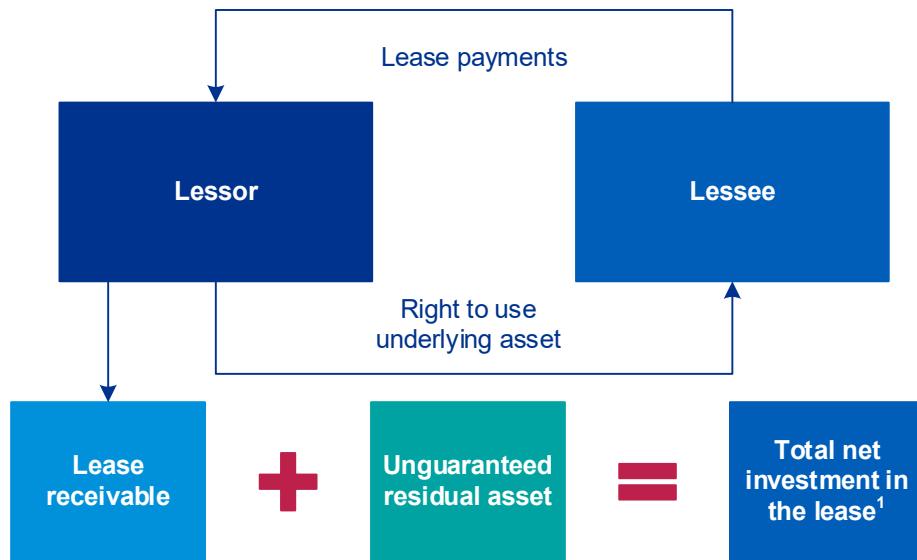
**55-33** At the commencement date, Lessor derecognizes the equipment and recognizes a net investment in the lease of \$56,000, which is equal to the carrying amount of the underlying asset of \$54,000 plus the initial direct costs of \$2,000 that are included in the measurement of the net investment 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).

*[The remainder of Example 1 Case C is not included in this section because it is not relevant – it is included in section 7.3.2]*

7.3.10 For sales-type and direct financing leases, a lessor recognizes a net investment in the lease on its balance sheet and derecognizes the underlying asset. [842-30-25-1, 25-7, 40-1]



Note:

- If the lease is a direct financing lease, any selling profit is deferred and the deferred selling profit reduces the net investment in the lease.

### ***Net investment in the lease***

7.3.20 For a sales-type lease, the lessor's net investment in the lease comprises: [842-30-30-1]

- a lease receivable (see paragraph 7.3.50); and
- an unguaranteed residual asset for the lessor's interest in the underlying asset's estimated future value at the end of the lease term that is not guaranteed by either:
  - the lessee; or
  - another third party unrelated to the lessor.

7.3.30 For a direct financing lease, the lessor's net investment in the lease comprises: [842-30-25-8, 30-2]

- a lease receivable and an unguaranteed residual asset (calculated in the same way as for a sales-type lease); less
- any selling profit on the lease, which is deferred and recognized over the lease term; it is not recognized at lease commencement as it is for a sales-type lease.

7.3.35 For both sales-type and direct financing leases, any initial direct costs of the lessor that are deferred are automatically included in the net investment in the lease based on how the rate implicit in the lease is calculated (see sections 5.5 and 5.6.1, and paragraph 7.3.60). They are not deferred separately.

7.3.40 The selling profit or selling loss for a sales-type or direct financing lease is: [842 Glossary]

- the lower of: (1) the fair value of the underlying asset (see paragraph 7.3.41) or (2) the sum of the lease receivable + any prepaid lease payments;

- minus the carrying amount of the underlying asset, net of any unguaranteed residual asset;
- minus any initial direct costs (see section 5.5) of the lessor that are deferred (i.e. capitalized) (see paragraph 7.3.60).

7.3.41 The fair value of the underlying asset for purposes of lessor accounting under Topic 842 differs depending on whether the lessor is a manufacturer or dealer. [842-30-55-17A]

- For lessors that are manufacturers or dealers, the fair value of the underlying asset is determined in accordance with Topic 820 (fair value measurement).
- For lessors that are *not* manufacturers or dealers (typically, financial institutions), the fair value of the underlying asset is its cost, reflecting volume or trade discounts. Cost includes acquisition costs such as those arising from sales taxes, shipping/delivery and installation. An exception arises if a significant period of time elapses between asset acquisition and lease commencement. In those cases, the lessor determines fair value in the same way as a manufacturer or dealer lessor.



### Example 7.3.05

#### Fair value of the underlying asset

Lessor LR (a bank) leases a machine to Lessee LE for use in its production facility for three years. LE selected the make and model machine it wanted LR to acquire and lease to LE and negotiated the purchase price of the machine with the manufacturer.

The following reflects costs incurred by LR in connection with acquiring the machine.

Machine purchase price:	\$100,000
Sales tax (7% of the purchase price): <sup>1</sup>	\$7,000
Delivery charge: <sup>2</sup>	\$1,000
Installation charge: <sup>3</sup>	\$2,000
<b>Total LR payments</b>	<b>\$110,000</b>

Notes:

1. LE will operate the machine in a US state that imposes sales tax on the purchase of the machine, based on its purchase price, rather than on the lease payments that LE will make to LR.
2. Represents the charge from the manufacturer for delivering the machine to LE's production facility.
3. Manufacturer installs the machine in LE's production facility, which is necessary for its use.

LR acquired the machine, based on the date it obtained title, on the same day that the machine was delivered to LE and installed at LE's production facility.

The fair value of the machine to LR for purposes of applying lessor accounting under Topic 842 is \$110,000. Because (1) LR is not a manufacturer or dealer, and (2) LR's acquisition date of the machine coincides with the lease commencement date, the fair value of the machine includes the sales taxes and the delivery and installation charges incurred to acquire the machine, bring it to LE's location and ready it for its intended use.



### Observation

#### Fair value of the underlying asset for lessors that are not manufacturers or dealers

7.3.42 The guidance in paragraph 7.3.41 was added to Topic 842 by ASU 2019-01 (issued in March 2019), and changes how lessors that are not manufacturers or dealers determine the fair value of the underlying asset when applying the Topic 842 lessor accounting requirements.

7.3.43 Before the issuance of ASU 2019-01, all lessors subject to Topic 842 were required to determine the fair value of the underlying asset based on the guidance in Topic 820 (fair value measurement). Applying Topic 820, lessors generally concluded that acquisition costs – costs to acquire the underlying asset (e.g. sales taxes) and place it into service (e.g. delivery and installation costs) – would *not* be included in the underlying asset's fair value.

7.3.44 The most important consequence was that the lessor in a sales-type or direct financing lease would expense those costs (i.e. recognize a loss) at lease commencement. This is because the cost basis of the asset to be derecognized would include those costs, while the net investment in the lease (which is measured at the fair value of the underlying asset plus any deferred initial direct costs) would not. [\[ASU 2019-01.BC8, BC12\]](#)

7.3.45 The lessor in this scenario would recover the up-front loss through interest income earned over the lease term. The lessor's interest income would be greater than what results from applying the new guidance in paragraph 7.3.41 because the lower fair value (before ASU 2019-01) resulted in a higher rate implicit in the lease. [\[ASU 2019-01.BC12\]](#)

7.3.46 Lessors, in particular financial lessors (e.g. banks), expressed to the FASB that the accounting did not reflect the economics of their lease arrangements: recording an up-front loss for acquisition costs on sales-type leases that do not give rise to selling profit (or loss) and direct financing leases, and then recognizing higher interest income over the lease term to recover that loss; in substance, the arrangements are just loans to the lessee. The acquisition costs are, in those arrangements, just part of the total loan being provided to the lessee, intended in total to be recovered (with interest) by the lessor over the lease term. Lessors asserted that treating the acquisition cost portion of the loan differently from the remainder of the loan was illogical.

7.3.47 The FASB, in issuing ASU 2019-01, agreed with the lessors, and noted that it was not the Board's intent when creating Topic 842 to change financial lessors' accounting in this manner. [\[ASU 2019-01.BC13\]](#)



### Question 7.3.01

#### **Effect of a government grant toward the cost of an underlying asset on the asset's fair value**

**How does a grant, received by a lessor from a governmental agency as an incentive to build an asset to be leased, affect the asset's fair value?**

**Background:** A governmental agency offers a lessor a \$2 million incentive to build a manufacturing facility in a specific location that it will lease to a manufacturer. The agency believes the incentive will induce a manufacturer to conduct its manufacturing in the area, creating jobs and increasing the local tax base. The incentive is available to any lessor willing to enter into an agreement to construct such a facility.

**Interpretive response:** If the lessor is neither a manufacturer nor a dealer (e.g. a financial institution), the fair value of the underlying asset at lease commencement is its cost; cost reflects any volume or trade discounts that may apply (see paragraph 7.3.41). Because the government grant is available to any lessor that would construct the facility, we believe the total cost of the facility should be reduced by the government grant to determine its fair value.



### Question 7.3.02

#### **Fair value in a build-to-suit lease**

**If construction of a new asset takes significant time, and is completed close to the lease commencement date, should the cost of the asset be considered its fair value if the lessor is not a manufacturer or dealer?**

**Interpretive response:** Yes. We believe the construction completion date should be considered the acquisition date of the asset. Therefore, if the lessor is not a manufacturer or dealer, and there is not a significant time lapse between the construction completion date and lease commencement, the fair value of the asset is its cost, reflective of any volume or trade discounts applied.



### Question 7.3.10

#### Estimated residual value of land in a long-term sales-type or direct financing lease

**When a long-term land lease is determined to be a sales-type or direct financing lease, can the estimated residual value of the land (undiscounted) exceed its fair value at the lease commencement date?**

**Background:** Land will frequently appreciate in value over a given lease term, particularly over a lengthy lease term, such that the value a lessor would expect to derive from leased land following the end of the lease term may exceed the land's fair value at lease commencement.

The estimated residual value of an underlying asset affects the measurement of the lease receivable (to the extent it is guaranteed by the lessee or a third party unrelated to the lessor) and/or the unguaranteed residual asset (to the extent it is not guaranteed).

Under Topic 840, the estimated residual value was limited to the fair value of the land at lease inception.

**Interpretive response:** No. We believe the estimated, undiscounted residual value of the land in a long-term sales-type or direct financing lease is limited to its fair value as of the lease commencement date. Using an estimated residual value that exceeds the commencement date fair value of the land (or any underlying asset) would inappropriately result in accounting for potential future fair value increases, including recognizing additional selling profit on a sales-type lease.

### Lease receivable

7.3.50 For a sales-type lease or a direct financing lease, the lessor initially measures the lease receivable at the present value of the following, discounted at the rate implicit in the lease (see section 5.6.1): [842-30-30-1(a), 30-2]

- future lease payments receivable over the lease term; and
- any portion of the estimated residual value at the end of the lease term that is guaranteed (either by the lessee or by a third party unrelated to the lessor).



### Selling profit/(loss) and initial direct costs

7.3.60 At lease commencement, a lessor recognizes any selling profit/(loss) and initial direct costs as follows. [842-30-25-1, 25-7 – 25-8, 30-2]

Sales-type lease	Direct financing lease
<b>Selling profit</b>	
Recognize at lease commencement.	Defer as a reduction of the net investment in the lease.
<b>Selling loss</b>	
Recognize at lease commencement.	
<b>Initial direct costs</b>	
<p>If the fair value of the underlying asset does not equal its carrying amount:</p> <ul style="list-style-type: none"> <li>— expense at lease commencement; and</li> <li>— exclude from determination of the rate implicit in the lease (see Example 7.3.20, Scenario 1).</li> </ul> <p>If the fair value of the underlying asset equals its carrying amount:</p> <ul style="list-style-type: none"> <li>— defer and include in the net investment in the lease;<sup>1</sup> and</li> <li>— include in determination of the rate implicit in the lease (see Example 7.3.20, Scenario 2).</li> </ul>	Defer and include in the net investment in the lease. <sup>1</sup> Include in determination of the rate implicit in the lease (see Examples 7.3.10 and 7.3.40).

Note:

1. The rate implicit in the lease is defined in such a way that the initial direct costs eligible for deferral are automatically included in the net investment in the lease; there is no need to add them separately.

### ***Unguaranteed residual asset***

7.3.70 A lessor initially measures the unguaranteed residual asset as the present value of the amount that the lessor expects to derive from the underlying asset following the end of the lease term that is not guaranteed by the lessee or any other third party unrelated to the lessor, discounted using the rate implicit in the lease. [842-30-30-1(b), 30-2]

### ***Collectibility considerations***

7.3.80 Notwithstanding the guidance on the initial recognition and measurement of a sales-type lease included in the preceding paragraphs (7.3.10 – 7.3.70), an exception arises if collectibility of the lease payments and any lessee residual value guarantee is not probable. For a discussion of the accounting that applies if collectibility of the lease payments and any lessee residual value guarantee is not probable (see section 7.5). [842-30-25-3 – 25-6]



### Example 7.3.10

#### Recognition of selling profit for a direct financing lease

Lessor LR leases a non-specialized machine to Lessee LE for three years. The following facts are relevant at the lease commencement date.

Lease payments:	Fixed payments of \$10,500 per year in arrears
Renewal/purchase options:	None
Transfer of ownership:	No
Fair value of machine:	\$40,000
Carrying amount of machine:	\$36,000
Remaining economic life of machine:	5 years
Estimated future residual value:	\$12,500
Residual value guarantee (third party other than LE):	\$9,200
Rate implicit in the lease:	3.15%
Initial direct costs:	\$1,000

In addition:

- At the commencement date, the present value of the future lease payments is 95% of the fair value of the machine (with the residual value guarantee), and 74% of the fair value of the machine (without the residual value guarantee).
- There are no prepaid lease payments.

#### Lease classification

In this example, the lease is a direct financing lease as a result of the third-party (non-lessee) residual value guarantee, which is included in the present value test only in Part B (see flowchart in paragraph 7.2.50).

#### Initial measurement

At the commencement date, LR records the following journal entry.

	Debit	Credit
Lease receivable <sup>1</sup>	37,994	
Unguaranteed residual asset <sup>2</sup>	3,006	
PP&E – machine		36,000
Deferred profit <sup>3</sup>		4,000
Cash <sup>4</sup>		1,000
<i>To recognize direct financing lease.</i>		
Notes:		
1. Present value of contractual lease payments ( $\$10,500 \times 3$ ) + residual value guarantee (\$9,200), discounted at 3.15%.		

2. Present value of unguaranteed residual asset of \$3,300 ( $\$12,500 - \$9,200$ ), discounted at 3.15%.
3. Fair value of underlying asset (\$40,000) – carrying amount (\$36,000). This is the same as the difference between the lease receivable (\$37,994) and the carrying amount of the machine, net of the unguaranteed residual asset (\$32,994), less deferred initial direct costs (\$1,000).
4. Represents lessor cash outlay for initial direct costs.

This example is continued in Example 7.3.40 (subsequent accounting).



### Example 7.3.20

#### **Accounting for initial direct costs in a sales-type lease**

##### **Scenario 1: Fair value of underlying asset does not equal its carrying amount**

Lessor LR leases a commercial truck to Lessee LE for five years. The following facts are relevant at the lease commencement date.

Lease payments:	Fixed payments of \$10,500 per year in arrears; none are prepaid
Renewal/purchase options:	None
Transfer of ownership:	No
Fair value of truck:	\$56,000
Carrying amount of truck:	\$53,000
Total economic life of truck:	12 years
Remaining economic life of truck:	6 years
Estimated future residual value:	\$15,000
Initial direct costs:	\$400

##### **Lease classification**

In this example, the lease is a sales-type lease because the lease term of five years represents a major part (i.e. 83%) of the underlying asset's remaining economic life (see flowchart in paragraph 7.2.30).

##### **Calculation of rate implicit in the lease**

At lease commencement, the fair value of the truck is different from its carrying amount. Therefore, the initial direct costs will be expensed at lease commencement and the rate implicit in the lease is determined based on the fair value of the underlying asset, without regard to initial direct costs. The rate implicit in the lease is therefore 5.68%, determined as follows.

Year	Initial investment	Lease payments	Residual value	Net receipts/payments
0	<b>\$(56,000)</b>	\$ -	\$ -	\$(56,000)
1		10,500	-	10,500
2		10,500	-	10,500
3		10,500	-	10,500
4		10,500	-	10,500
5		10,500	15,000	25,500
				<b>Rate 5.68%</b>

### Scenario 2: Fair value of underlying asset equals its carrying amount

Assume the same facts as Scenario 1, except that, at the lease commencement date, the truck has a fair value and a carrying amount to LR of \$56,000.

In this scenario, because the fair value of the truck equals its carrying amount at lease commencement, the initial direct costs of \$400 are considered when determining LR's implicit rate, and are deferred as part of the net investment in the lease as a result of the implicit rate determined. The rate implicit in the lease is therefore 5.45%, determined as follows.

Year	Initial investment	Lease payments	Residual value	Net receipts/payments
0	<b>\$(56,400)</b>	\$ -	\$ -	\$(56,400)
1		10,500	-	10,500
2		10,500	-	10,500
3		10,500	-	10,500
4		10,500	-	10,500
5		10,500	15,000	25,500
				<b>Rate 5.45%</b>

### Comparing Scenarios 1 and 2

Including the initial direct costs of \$400 when determining the rate implicit in the lease in Scenario 2 results in deferring the initial direct costs and recognizing them in net income through lower interest income over the lease term as compared to Scenario 1 (in which the initial direct costs are expensed at lease commencement).



## Observation **Selling profit or loss**

### **Selling profit deferred for direct financing leases at lease commencement and recognized over the lease term**

7.3.90 Lessors are required to defer selling profit arising from a direct financing lease. Direct financing leases exist in Topic 842 because the Board concluded that a lease is not a sales-type lease unless the customer, in effect, obtains control of – i.e. the ability to direct the use of, and obtain substantially all the remaining benefits from – the underlying asset as a result of the lease. This customer perspective is consistent with the customer perspective of a sale in Topic 606. The Board considered that it would be inappropriate, and would potentially create structuring opportunities for entities that are typically sellers (rather than lessors), to recognize selling profit by structuring a transaction in which control does not pass to the customer as a lease. [ASU 2016-02.BC95]

7.3.100 However, the Board still recognized that a lessor might effectively convert its risk arising from ownership of the underlying asset (i.e. asset risk) into credit risk. It concluded that the most faithful representation of the lessor's involvement in a lease in that case is to recognize a *financial* net investment in the lease and financial (interest) income on that net investment. [ASU 2016-02.BC96]

### **Selling loss recognized at lease commencement for sales-type and direct financing leases**

7.3.110 Even though a lessor defers selling *profit* arising from a direct financing lease under Topic 842, it recognizes at lease commencement any selling *loss* on a direct financing lease. If the lessor considers other applicable guidance (e.g. the long-lived assets or inventory impairment guidance), that guidance would generally result in recognition of a loss on the underlying asset. For example, the pricing in the lease might be evidence that the cash flows to be derived from the underlying asset will be less than its carrying amount, resulting in the recognition of an impairment. Therefore, the approach of recognizing a selling loss up-front is consistent with the idea that the presence of the selling loss might just be indicative of an existing impairment. [ASU 2016-02.BC98]



## Question 7.3.20

### **Differences between a lessor's lease receivable and a lessee's lease liability**

### **Is the measurement of the lessor's lease receivable and the lessee's lease liability expected to be the same?**

**Interpretive response:** Generally, no. The measurement of the lessor's lease receivable will typically differ from the measurement of the lessee's lease liability. The following are just some of the reasons for that difference.

- The lessor's lease receivable includes the present value of any residual value guarantee (whether obtained from the lessee or another third party

unrelated to the lessor). The lessee's lease liability includes only the present value of amounts that it is probable will be owed to the lessor under a residual value guarantee that it provides.

- The lessor always uses its implicit rate as the discount rate for the lease. The lessee typically uses its incremental borrowing rate as the discount rate for the lease because the information it would need to determine the lessor's implicit rate is generally not readily determinable (see Question 5.6.20).
- In addition to the fact that the amount of initial direct costs for the lessee and the lessor typically differs, the lessor either expenses initial direct costs at lease commencement or includes such amounts in its net investment in the lease – i.e. because the initial direct costs are deferred through the implicit rate, they are included in both the lease receivable and the unguaranteed residual asset. In contrast, the lessee includes initial direct costs in the measurement of its ROU asset, rather than as part of its lease liability.

Other measurement differences will arise in practice due to information asymmetry; for example, different assessments as to whether it is reasonably certain that the lessee will exercise a renewal or a purchase option.



### Question 7.3.25 **Lease incentives paid before lease commencement**

#### **How should a lessor account for a lease incentive paid before lease commencement?**

**Interpretive response:** If a lessor pays a lease incentive to a lessee before lease commencement, the lessor records the lease incentive paid as a deferred cost. The accounting at lease commencement then depends on the classification of the lease.

- For sales-type and direct financing leases, the deferred cost is derecognized:
  - as a reduction of the selling profit (or increase of the selling loss) arising from the lease (see paragraph 7.3.40); or
  - against sales/product revenue if the lessor presents revenue and cost of goods sold for its leases separately (see paragraph 7.7.20).
- For operating leases, the lessor commences amortization of the deferred cost, which will be recognized as a reduction of lease income over the lease term on the same basis as lease income (generally, straight-line) (see section 7.4).



## Question 7.3.26

### Contingent lease incentives

#### How should a lessor account for contingent lease incentives it offers to the lessee?

**Background:** Lessors frequently offer lease incentives that are contingent on future events or lessee actions – i.e. the incentives are not paid or payable – at lease commencement.

For example, lessors offer to reimburse lessees for all or a portion of the cost of leasehold improvements. To receive the reimbursement, the lessee must construct or install the leasehold improvements and provide evidence of the costs incurred. This may result in a one-time incentive that occurs at a specified point in time after lease commencement or may involve multiple payments made during the lease term when the lessee incurs incremental leasehold improvement costs – e.g. a payment to the lessee or a reduction of rent each year that the lessee incurs leasehold improvement costs above a specified amount (i.e. tenant improvement allowance).

Question 6.6.80 addresses lessee accounting for contingent lease incentives.

**Interpretive response:** We believe that if the occurrence of the future event or change in circumstance that triggers the contingent lease incentive (or portion thereof) is probable at lease commencement and the amount is reasonably estimable, the expected amount should be estimated and accounted for by the lessor as a negative in-substance fixed lease payment – i.e. as a reduction of ‘lease payments’. The expected timing of payment should also be considered when discounting the lease payments for classification and measurement purposes.

Using the background example, if a lessor offers a payment to the lessee or a reduction of rent each year that the lessee incurs leasehold improvement costs above a specified amount, it may be probable that the lessee will earn the full amount it negotiated. In that case, we believe the incentive should be accounted for at lease commencement as a reduction of the remaining lease payments due under the contract.

The reduction to the lease payments affects the classification of the lease and results in a lower implicit rate for the lease (see sections 7.2 and 5.6.1, respectively). Consequently, as compared to a lease without a similar incentive:

- for a sales-type or direct financing lease, the interest income recognized over the lease term will be lower (see Example 7.3.25); and
- for an operating lease, operating lease income recognized over the lease term will be lower (see section 7.4.2).

If the lessor does not include a contingent lease incentive in the lease payments at lease commencement – i.e. because payment of the incentive is not probable and/or not reasonably estimable – we believe the lessor can elect as an accounting policy either of the following approaches to account for the contingent incentive.

**Approach 1: Account for the incentive as a variable lease payment**

Account for the incentive as a 'negative' variable lease payment (i.e. a reduction of lease income) in the period in which the change in facts and circumstances on which the relevant payment is based occurs.

**Approach 2: Recognize the incentive as a change in the lease payments**

Account for a contingent incentive that becomes probable of being owed and reasonably estimable as a change in the 'lease payments', recognizing the effect of the change to lease income over the remaining lease term either:

- with cumulative effect; or
- prospectively.

**Example 7.3.25****Contingent lease incentive – sales-type lease**

This example compares a sales-type lease without a contingent lease incentive to a sales-type lease with a contingent lease incentive.

**Scenario 1: No lease incentive**

Assume the same facts as Example 7.3.20 (Scenario 1). In that scenario, the lease is a sales-type lease and the rate implicit in the lease is 5.68%.

The following table summarizes the amounts arising on Lessor LR's balance sheet (on which LR presents its net investment in the lease, rather than the components in the table) and income statement.

End of year	Balance sheet				Income statement			
	Lessee payments receivable <sup>1</sup>	Incentive payable <sup>1</sup>	Unguar. residual asset	Net invest. in lease <sup>2</sup>	Interest on lease receivable, net <sup>3</sup>	Residual accretion <sup>3</sup>	Selling profit <sup>4</sup>	Total income
0	\$44,620	\$ -	\$11,380	\$56,000	\$ -	\$ -	\$3,000	\$3,000
1	36,654	-	12,026	48,680	2,533	647	-	3,180
2	28,235	-	12,709	40,944	2,081	683	-	2,764
3	19,338	-	13,431	32,769	1,604	721	-	2,325
4	9,936	-	14,194	24,130	1,098	763	-	1,861
5	-	-	15,000	15,000	564	806	-	1,370
<b>Totals</b>					<b>\$7,880</b>	<b>\$3,620</b>	<b>\$3,000</b>	<b>\$14,500</b>

Notes:

1. The lessee payments receivable and incentive payable *together* comprise the 'lease receivable'.
2. The components of the net investment in the lease are measured at present value using the rate implicit in the lease of 5.68%.
3. Interest on the lease receivable and unguaranteed residual asset accretion are calculated using the rate implicit in the lease of 5.68%.
4. Selling profit (recognized at lease commencement) is the difference between the lease receivable, net (\$44,620) and the carrying amount of the equipment net of the unguaranteed residual asset (\$53,000 – \$11,380 = \$41,620).

### Scenario 2: Lessor pays incentive fee in Year 2

Assume the same facts as Scenario 1, except that the lease contract requires LR to pay LE an incentive of up to \$2,500 for LE costs of tenant improvements.

LR expects LE to install tenant improvements significantly in excess of \$2,500, so concludes that payment of the incentive is both probable and the amount reasonably estimable at lease commencement. LR anticipates LE completing the improvements at or near the end of Year 2 of the lease, so expects to pay the incentive at that time.

The estimated incentive reduces the lease payments but could not affect the sales-type classification of the lease because, regardless of the incentive, the lease term is for a major part of the remaining economic life of the underlying asset.

The rate implicit in the lease is calculated as follows.

Year	Initial investment	Lease payments <sup>1</sup>	Residual value	Net receipts/payments
0	<b>\$ (56,000)</b>	\$ -	\$ -	\$ -
1		10,500	-	10,500
2		8,000	-	8,000
3		10,500	-	10,500
4		10,500	-	10,500
5		10,500	15,000	25,500
			<b>Rate</b>	<b>4.41%</b>

Note:

1. The lease payment in Year 2 is net of the estimated incentive payment of \$2,500.

The following table summarizes the amounts arising on LR's balance sheet (on which LR presents its net investment in the lease, rather than the components in the table) and income statement.

End of year	Balance sheet				Income statement			
	Lessee payments receivable <sup>1</sup>	Incentive payable <sup>1</sup>	Un Guar. residual asset	Net invest. in lease <sup>2</sup>	Interest on lease receivable <sup>3</sup>	Residual accretion <sup>3</sup>	Selling profit <sup>4</sup>	Total income <sup>3</sup>
0	\$46,206	\$ (2,293)	\$12,087	\$56,000	\$ -	\$ -	\$3,000	\$ 3,000
1	37,745	(2,394)	12,620	47,971	1,938	533	-	2,471
2	28,911	-	13,177	42,088	1,560	557	-	2,117
3	19,687	-	13,759	33,446	1,276	582	-	1,858
4	10,056	-	14,366	24,422	869	607	-	1,476
5	-	-	15,000	15,000	444	634	-	1,078
				<b>Totals</b>	<b>\$6,087</b>	<b>\$2,913</b>	<b>\$3,000</b>	<b>\$12,000</b>

Notes:

1. The lessee payments receivable and incentive payable together comprise the 'lease receivable'.

2. The components of the net investment in the lease are measured at present value using the rate implicit in the lease of 4.41%.
3. Interest on the lease receivable and unguaranteed residual asset accretion are calculated using the rate implicit in the lease of 4.41%.
4. Selling profit (recognized at lease commencement) of \$3,000 is the difference between the lease receivable (\$46,206 – \$2,293 = \$43,913) and the carrying amount of the equipment net of the unguaranteed residual asset (\$53,000 – 12,087 = \$40,913).

### Comparing Scenario 1 and Scenario 2

The incentive lowers the rate implicit in the lease from 5.68% in Scenario 1 to 4.41% in Scenario 2.

The following table compares the lease commencement date carrying amounts of the components of the net investment of the lease under Scenario 1 to those under Scenario 2.

<b>Balance sheet (initial measurement at lease commencement)</b>				
	<b>Lessee payment receivable</b>	<b>Incentive payable</b>	<b>Unguaranteed residual asset</b>	<b>Net investment in lease</b>
Scenario 1	\$44,620	\$ -	\$11,380	\$56,000
Scenario 2	46,206	(2,293)	12,087	56,000
<b>Difference</b>	<b>\$1,586</b>	<b>\$(2,293)</b>	<b>\$707</b>	<b>\$ -</b>

While the carrying amounts of the individual components of the net investment in the lease are different in the two scenarios because of the incentive, the net investment in aggregate is the same. This is because of how the rate implicit in the lease is calculated.

The following table compares the selling profit and interest income recognized under each scenario.

<b>Income statement (total during lease term)</b>				
	<b>Interest on lease receivable</b>	<b>Residual accretion</b>	<b>Selling profit</b>	<b>Total income</b>
Scenario 1	\$7,880	\$3,620	\$3,000	\$14,500
Scenario 2	6,087	2,913	3,000	12,000
<b>Difference</b>	<b>\$(1,793)</b>	<b>\$(707)</b>	<b>\$ -</b>	<b>\$(2,500)</b>

Total income to be recognized is lower in Scenario 2 than in Scenario 1 by the amount of the estimated incentive.

- Interest income to be recognized on the lease receivable and from accretion of the unguaranteed residual asset is lower in Scenario 2 than in Scenario 1 because of the lower implicit rate.
- Selling profit is the same in both scenarios. The lower implicit rate in Scenario 2, which affects the carrying amounts of the components of the

net investment in the lease (and drives the calculation of selling profit – see paragraph 7.3.40), offsets the effect of the lease incentive.

Selling profit calculation		
	Scenario 1	Scenario 2
Lease receivable	\$44,620	\$43,913
+ prepaid lease payments	-	-
- carrying amount of underlying asset (net of unguaranteed residual asset)	(41,620)	(40,913)
<b>Selling profit</b>	<b>\$3,000</b>	<b>\$3,000</b>



### Question 7.3.30

**Impact of variable lease payments on the rate implicit in the lease**

#### How does the lessor determine the rate implicit in the lease when the lease includes variable lease payments?

**Background:** It is not uncommon in certain industries for a lease to be comprised primarily, or even entirely, of variable lease payments. The following are examples (not exhaustive):

- In the oil and gas industry, an entity may contract with a third-party midstream company to lease the necessary equipment to extract and process oil or gas from certain well sites. The midstream company may accept a lease agreement that includes entirely variable lease payments based on the volume of oil or gas extracted and processed if data suggests the well sites include a significant volume available for extraction.
- In the energy sector, power purchase agreements with renewable energy facilities are commonly structured with payments based on a set price per unit of electricity output, but the total volume purchased in a given period is variable. For example, an entity contracts to purchase the total electricity output of a wind farm at a fixed price per unit. The volume of electricity purchased in a given month is variable depending on the volume of electricity produced. If the agreement meets the definition of a lease (see chapter 3), the lease payments would be variable in their entirety.
- In the health care industry, service providers may contract with medical device companies to lease equipment that is dependent on the service provider's continued purchase of materials from the medical device company necessary to operate the equipment as designed – i.e. the equipment is leased 'for free' based on the expectation that the service provider will purchase materials from the medical device company over the lease term. The medical device company may be willing to accept a lease agreement where payments for the equipment are entirely dependent on the volume of materials purchased because it expects that the service

provider will require a sufficient volume of materials to operate the equipment such that the contract as a whole will be profitable.

**Interpretive response:** For leases with variable lease payments, especially those with significant variable lease payments, the undiscounted sum of (1) the lease payments and (2) the estimated residual value of the underlying asset at the end of the lease term may be less than the underlying asset's fair value and/or carrying amount at lease commencement. As discussed in section 5.4.1, this is because variable lease payments that do not depend on an index or a rate are excluded from the lease payments.

In the event that the rate implicit in the lease would be negative from applying the calculated formula in the implicit rate definition because of the variable lease payments, a discount rate of zero is used. A lessor does not, in such cases, use another discount rate for the lease such as the lessee's incremental borrowing rate or a rate that estimates the variable lease payments.



### Example 7.3.31

#### Impact of variable lease payments

##### Scenario 1: Lease comprised entirely of variable lease payments

Lessor LR enters into a contract with Lessee LE to lease a non-specialized machine for five years. The contract is structured such that payments from LE to LR related to use of the underlying asset are based entirely on LE's use of the machine. LR intends to sell the machine at auction after the lease with LE ends.

The following facts are relevant at the lease commencement date.

Variable lease payments:	3% of LE's monthly sales of units produced using the machine
Renewal/purchase options:	None
Transfer of ownership:	No
Fair value of machine:	\$40,000
Carrying amount of machine:	\$36,000
Lease term:	5 years
Remaining useful life of machine:	5 years
Remaining economic life of machine:	6 years
Estimated future residual value:	\$12,500
Residual value guarantee:	None

##### Classification and initial measurement

LR is unable to calculate a rate implicit in the lease that is greater than zero because the sum of (1) the lease payments (\$0, because the lease payments are entirely variable) and (2) the estimated residual value of the machine at the

end of the lease term (\$12,500) is less than the machine's fair value at the lease commencement date. Therefore, LR uses a 0% discount rate.

Because the amount that would be recognized as the net investment in the lease (\$12,500) if the lease were classified as a sales-type or direct financing lease is less than the machine's carrying amount (\$36,000) at the lease commencement date such that a selling loss would result, LR classifies the lease as an operating lease (see paragraph 7.2.30).

### Subsequent accounting

As an operating lease, LR continues to recognize the machine and depreciate it over its useful life. LR records the variable lease payments (the only payments for the lease under the contract) as revenue in the period(s) in which the sales of units produced using the machine occur.

End of year	Balance sheet PP&E (net)	Income statement		
		Depn. expense <sup>2</sup>	Variable lease income <sup>1</sup>	Total earnings impact
0	\$36,000	\$ -	\$ -	\$ -
1	31,300	(4,700)	12,000	7,800
2	26,600	(4,700)	9,500	4,800
3	21,900	(4,700)	14,500	9,800
4	17,200	(4,700)	9,000	4,300
5	12,500	(4,700)	10,000	5,300
		<b>(\$23,500)</b>	<b>\$55,000</b>	<b>\$ 31,500</b>

Notes:

- Assumed variable lease payments, which are based on 3% of hypothetical LE monthly sales of units produced using the machine.
- Calculated on a straight-line basis (\$36,000 carrying amount less the estimated residual value of \$12,500) over the machine's 5-year useful life.

### Scenario 2: Lease comprised partially of variable lease payments

Assume the same facts as Scenario 1, except that a portion of the lease payments are variable (1.5% of LE's monthly sales of units produced using the machine) and a portion are fixed (\$5,500 per year).

### Classification and initial measurement

LR is unable to calculate a rate implicit in the lease that is greater than zero because the sum of (1) the lease payments (\$27,500) and (2) the estimated residual value of the machine at the end of the lease term (\$12,500) equals the machine's fair value at the lease commencement date. Therefore, LR uses a 0% discount rate.

Because the amount that would be recognized as the net investment in the lease (\$40,000) if the lease were classified as a sales-type or direct financing lease is greater than the machine's carrying amount (\$36,000) at the lease commencement date, the lease passes the Step 0 classification test (see paragraph 7.2.30).

Applying the Part A lease classification tests (see paragraph 7.2.30), the lease is a sales-type lease because the lease term of five years represents a major part (83%) of the machine's remaining economic life.

	Debit	Credit
Unguaranteed residual asset <sup>1</sup>	12,500	
Lease receivable <sup>2</sup>	27,500	
PP&E – machine		36,000
Selling profit <sup>3</sup>		4,000
<i>To recognize unguaranteed residual asset, lease receivable and up-front selling profit, and derecognize underlying asset at commencement date.</i>		
Notes:		
1. Estimated future residual value (\$12,500) discounted at 0%.		
2. Fixed lease payments (\$5,500 × 5) discounted at 0%.		
3. Sum of (1) the lease payments (\$27,500) and (2) any prepaid lease payments (\$0) – the net of (1) the carrying amount of the machine (\$36,000) and (2) the unguaranteed residual asset (\$12,500).		

### Subsequent accounting

Because the discount rate is 0%, there is no accretion of the unguaranteed residual asset or interest on the lease receivable during the lease term. LR recognizes the variable lease payments as revenue in the period(s) in which the sales of units produced using the machine occur. The following table summarizes the income statement effect to LR throughout the lease term.

End of year	Net investment in the lease <sup>1</sup>	Income statement			Total earnings impact
		Interest on residual asset/lease receivable	Variable lease payments <sup>2</sup>		
0	\$40,000	\$ -	\$ -		\$ 4,000 <sup>3</sup>
1	34,500	-	6,000		6,000
2	29,000	-	4,750		4,750
3	23,500	-	7,250		7,250
4	18,000	-	4,500		4,500
5	12,500	-	5,000		5,000
		\$ -	<b>\$27,500</b>	<b>\$31,500</b>	

Notes:

- Because the rate implicit in the lease is zero, the changes in the balance of the net investment in the lease reflect solely the periodic (non-variable) lease payment of \$5,500 per year.
- Assumed variable lease payments, which are based on 1.5% of hypothetical LE monthly sales of units produced using the machine.
- Represents the selling profit in the initial measurement journal entry.

## Comparing Scenarios 1 and 2

The following table summarizes the total earnings effect to LR by year under Scenarios 1 and 2.

Year	Earnings impact	
	Scenario 1	Scenario 2
0	\$ -	\$ 4,000
1	7,800	6,000
2	4,800	4,750
3	9,800	7,250
4	4,300	4,500
5	5,300	5,000
	<b>\$31,500</b>	<b>\$31,500</b>

Even though the total earnings effect to LR over the lease term is the same under both scenarios, the lease classification significantly affects the timing of the earnings effect in LR's financial statements.

The following table compares LR's balance sheet at lease commencement and at the end of each year under Scenarios 1 and 2.

Year	Balance sheet comparison			
	Scenario 1 PP&E (net)		Scenario 2 Lease receivable and unguaranteed residual asset	
	Current <sup>1</sup>	Noncurrent <sup>2</sup>	Current <sup>3</sup>	Noncurrent <sup>4</sup>
0	\$ -	\$36,000	\$ 5,500	\$ 34,500
1	-	31,300	5,500	29,000
2	-	26,600	5,500	23,500
3	-	21,900	5,500	18,000
4	-	17,200	5,500	12,500
5	-	12,500	-	12,500

Notes:

1. There is no current period portion of a PP&E asset (i.e. the machine). This column is presented to show the difference in current assets between Scenario 1 and Scenario 2.
2. Represents the carrying amount (net of accumulated depreciation) of the machine at the end of each reporting period.
3. The current portion consists of nonvariable lease payments due within the following 12-month period.
4. The noncurrent balance includes the unguaranteed residual asset (\$12,500) and fixed lease payments due after the following 12-month period.

## 7.3.2 Subsequent accounting



### Excerpt from ASC 842-30

#### 25 Recognition

##### General

> Sales-Type Leases

**25-2** After the commencement date, a lessor shall recognize all of the following:

- a. Interest income on the net investment in the lease, measured in accordance with paragraph 842-30-35-1(a)
- b. **Variable lease payments** that are not included in the net investment in the lease as income in profit or loss in the period when the changes in facts and circumstances on which the variable lease payments are based occur
- c. Impairment of the net investment in the lease (as described in paragraph 842-30-35-3).

> Direct Financing Leases

**25-9** After the commencement date, a lessor shall recognize all of the following:

- a. Interest income on the net investment in the lease, measured in accordance with paragraph 842-30-35-1(a)
- b. **Variable lease payments** that are not included in the net investment in the lease as income in profit or loss in the period when the changes in facts and circumstances on which the variable lease payments are based occur
- c. Credit losses on the net investment in the lease (as described in paragraph 842-30-35-3).

#### 35 Subsequent Measurement

##### General

> Sales-Type and Direct Financing Leases

**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.

- > Loss Allowance on the Net Investment in the Lease

**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**.

- > Sale of the Lease Receivable

**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.

- > Accounting for the Underlying Asset at the End of the Lease Term

**35-5** At the end of the **lease term**, a lessor shall reclassify the **net investment in the lease** to the appropriate category of asset (for example, property, plant, and equipment) in accordance with other Topics, measured at the carrying amount of the net investment in the lease. The lessor shall account for the **underlying asset** that was the subject of a **lease** in accordance with other Topics.

## 40 Derecognition

### General

- > Sales-Type and Direct Financing Leases

- > Lease Termination

**40-2** If a **sales-type lease** or a **direct financing lease** is terminated before the end of the **lease term**, a lessor shall do all of the following:

- 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
- 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
- Account for the **underlying asset** that was the subject of the **lease** in accordance with other Topics.

## 55 Implementation Guidance and Illustrations

### General

- > Implementation Guidance
  - > Guarantee Payments Received

**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**.

- > Fair Value of the Underlying Asset

**55-17A** Notwithstanding the definition of **fair value**, if a lessor is not a manufacturer or a dealer, the fair value of the **underlying asset** at lease commencement is 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 underlying asset and lease commencement, the definition of fair value shall be applied.

- > Illustrations

- > 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 ( $\$56,920 - \$5,080 = \$48,920$ ). 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).

**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  $\$62,000 \times \text{the rate implicit in the lease of } 5.4839\% = \$3,400$ ), 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  $\$56,920 \times 5.4839\%$ ). 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  $\$5,081 \times 5.4839\%$ ).

**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.

••• > 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  $\$56,000 \times$  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  $\$58,669 \times 4.646\%$ ). 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  $\$5,331 \times 4.646\%$ ). 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  $\$51,124 \times 8.258\%$ , 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  $\$51,895 \times 4.646\%$ ). 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  $\$5,578 \times 4.646\%$ ). 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.

7.3.140 After the lease commencement date, the lessor recognizes:

- interest income on the net investment in the lease, as described in paragraph 7.3.340;
- variable lease payments as income in the income statement in the period in which the changes in facts and circumstances on which those payments are based occur; and
- impairment of the net investment in the lease, as described in paragraph 7.3.380. [842-30-25-2, 25-9]

7.3.150 A lessor recognizes variable non-lease payments as income in the income statement when the requirements of the applicable Topic (e.g. Topic 606) are met. [842-10-15-40]

### **Gross vs. net considerations**

7.3.160 Lessors frequently incur costs in their role as lessor or as owner of the underlying asset that they aim to recover from the lessee. Examples include property, ad valorem and other taxes, and insurance covering the underlying asset. [842-10-15-30(b), ASU 2018-20.BC14]

7.3.170 Lessors typically aim to recover these costs from the lessee, the payments for which do not result in the transfer of a good or service to the

lessee in addition to the lease and any non-lease goods or services included in the contract. [842-10-15-30(b), ASU 2018-20.BC14]

- In a gross lease, the lessor recovers the costs through fixed lease payments.
- In a net lease, the lessee makes variable payments, either to the lessor or directly to the third party to whom the cost is owed (e.g. a taxing authority or insurer).

7.3.180 In a gross lease, the lessor's costs and the lessee's fixed lease payments are recognized separately (i.e. on a gross basis) as operating expenses and lease income. If the lease includes non-lease components, there will be lease and non-lease income arising from the payments.

7.3.190 In a net lease, gross or net income statement presentation depends on whether the lessee or the lessor pays the relevant third party for the cost, unless the cost is a sales or other similar tax (see paragraph 7.3.210). [842-10-15-40A]

- If the **lessee** remits payment to the third party, the lessor presents the cost and the lessee's payment to the third party thereof on a net basis – i.e. with zero effect on the income statement. The lessor, in effect, treats the cost as a lessee cost. Example 4.2.50 in section 4.2.1 illustrates this scenario.
- If the **lessor** remits payment to the third party, the lessor presents the cost and the lessee's variable payments thereof on a gross basis – i.e. as its own cost and income. Example 4.2.40 in section 4.2.1 illustrates this scenario.

7.3.200 In applying paragraph 7.3.190, it does not matter whether the lessor or lessee is primarily obligated to the third party for the cost incurred, or who primarily benefits from the cost. The accounting by lessors differs from the accounting by lessees in this respect (see Question 4.2.40).

### Sales and other similar taxes

7.3.210 The guidance in paragraphs 7.3.180 – 7.3.200 does not apply to sales and other similar taxes if the lessor elects the practical expedient to present all sales tax collections from lessees (whether fixed or variable) net of the related sales tax expense for all of its leases. Questions 4.2.60 and 4.2.70 outline a lessor's accounting for sales and other similar taxes. [842-10-15-39A]

7.3.220 'Sales and other similar taxes' refers to taxes assessed by a governmental authority that are both imposed on and concurrent with a specific lease revenue-producing transaction. Other similar taxes include use, value-added taxes (VAT) and some excise taxes. Such taxes exclude (1) gross receipts taxes and (2) taxes assessed on the lessor as owner of the underlying asset. [842-10-15-39A]

7.3.230 Taxes assessed on the lessor as owner of the underlying asset include (not exhaustive):

- most property taxes; and
- sales taxes assessed on the owner's purchase of the underlying asset.

7.3.240 A lessor that does *not* elect the practical expedient applies the guidance in paragraphs 7.3.180 – 7.3.200 to sales and other similar taxes.

7.3.250 For transition considerations, see section 13A.4.3 (effective date transition method) or section 13B.4.3 (comparative transition method). The considerations depend on whether or not lessors adopted Topic 842 before the December 2018 issuance of ASU 2018-20.



## Observation **Lessor costs**

### **Lessor costs paid by the lessee directly to a third party**

7.3.260 It is not uncommon for a lessor not to know (or expect to know) the amount of a lessor cost the lessee pays directly to a third party. For example, a lessee may be required to obtain insurance on the underlying asset as a condition of the lease and for which the lessor is the primary beneficiary of that policy (see Question 4.2.42), but not be required to provide policy premium information to the lessor.

7.3.270 Because the premium may be affected by numerous lessee-specific factors (e.g. credit rating, claims history, discounts for multiple policies), or because an umbrella insurance policy covers the underlying asset, the lessor may not know what the premium is. In that case, the lessor will not be able to present the lessee's payments and its associated costs on a gross basis without estimating the premium.

7.3.280 The guidance in paragraph 7.3.190, added by ASU 2018-20, addresses lessor operational concerns about estimating lessee payments of lessor costs made directly to a third party. Because neither the costs nor the lessee payments thereof are reflected in the lessor's income statement, lessors will not need to make such estimates.

### **Lessor costs paid by the lessee to the lessor**

7.3.290 When the guidance in paragraph 7.3.190 was deliberated, some stakeholders suggested that net presentation in the income statement should also be mandated for lessor costs paid by the lessor and reimbursed by the lessee (lessee-reimbursed costs). Those stakeholders asserted that the underlying economics are not different for lessee direct pay costs and lessee-reimbursed costs, so should not be presented differently. [\[ASU 2018-20.BC18\]](#)

7.3.300 The FASB rejected this view in favor of the requirements in paragraphs 7.3.180 and 7.3.190. The FASB explained that it intended to require net presentation for those lessor costs for which there is uncertainty for the lessor as to the amount of the cost and the lessee's payment thereof; however, there is no uncertainty about the amount of the cost or the lessee's payment if the lessor pays the cost and collects the lessee's payment. [\[ASU 2018-20.BC22\]](#)



## Observation **Sales and other similar taxes**

7.3.310 A lessor may operate in numerous taxing jurisdictions. Similarly, the lessor's customers (i.e. the lessees) may operate the lessor's underlying assets

in numerous taxing jurisdictions. The primary obligor to the taxing authority for sales or other similar taxes can vary by jurisdiction – e.g. the primary obligor for sales or use taxes in one US state may be the lessor, while in another US state it may be the lessee. Because of this, lessors told the FASB that assessing different in-scope taxes on a jurisdiction-by-jurisdiction basis would be costly and complex.

7.3.320 If elected, the practical expedient in paragraph 7.3.210, added by ASU 2018-20, means that the lessor will not assess whether it or the lessee is the primary obligor for in-scope taxes. A lessor will also not account for in-scope taxes collected from the customer on a gross basis, as it will any other taxes for which it, rather than the lessee, remits payment to the taxing authority. Instead, all in-scope taxes will be accounted for as lessee costs, without having to make any further evaluation and regardless of who remits payment to the relevant taxing authority.



#### Question 7.3.40

#### **Sublessor gross vs. net considerations**

### **Does a sublessor follow the gross vs. net considerations guidance for sublessee payments of lessor costs?**

**Background:** Consider a scenario in which Head Lessee (Sublessor) LE and Head Lessor LR enter into a five-year lease of a building. Under the head lease, LE is required to make variable payments of LR's property taxes and insurance directly to the taxing authority and insurer, respectively. LE subsequently subleases the building to Sublessee SE and the sublease agreement transfers to SE the obligation to pay the property taxes and insurance on the building to the taxing authority and insurer. There are no non-lease components in either the head lease or sublease contracts.

**Interpretive response:** Yes. The gross versus net considerations in paragraphs 7.3.160 – 7.3.200 apply equally to head lessors and sublessors. This is because sublessors apply Topic 842's lessor accounting requirements to the sublease (see paragraph 8.2.60).

Using the background scenario to illustrate, LE presents its head lease building property tax and insurance costs and SE's variable payments thereof on a net basis – i.e. LE does not recognize either variable head lease cost or variable sublease income because those amounts are equal and therefore net to zero.

Changing the background scenario, assume LR pays the taxing authority and the insurer for the property taxes and insurance, LE is required to reimburse LR, and SE is required to reimburse LE in turn. In that scenario, LE would present its variable property tax and insurance payments to LR and SE's variable property tax and insurance payments to LE on a gross basis – i.e. as variable head lease cost and variable sublease income, respectively.



## Question 7.3.50

**Sublessee rental payments directly to a third party****Do the gross vs. net lessor cost requirements apply to variable rent payments?**

**Background:** It may be the case that a sublessee is required to make variable rent payments directly to the head lessor, rather than to the sublessor.

For example, Head Lessee (Sublessor) LE may sublease a building and its underlying land to Sublessee SE. LE previously owned the building and leased the underlying land from Landowner. LE sold the building and leases it back from Head Lessor LR. After the sale-leaseback transaction with LR, LE retains the requirement to make variable rent payments to Landowner for the ground lease. However, SE assumes the obligation to make those variable rent payments to Landowner as part of the sublease.

In this scenario, the question arises as to whether LE should present the variable rent paid by SE directly to Landowner on a gross or a net basis.

**Interpretive response:** No. We believe the requirements in paragraph 7.3.190 do not apply to variable rent payments, or any variable payments that relate to a non-lease component of the contract.

At a February 2018 FASB meeting, the Board affirmed the view of the FASB staff that the guidance in paragraph 7.3.190 applies only to lessee payments of the types of costs contemplated by paragraph 842-10-15-30(b) – i.e. costs incurred by the lessor in its role as lessor or as owner of the underlying asset, such as those from property taxes or insuring the underlying asset. The basis for conclusions to ASU 2018-20 effectively defines ‘lessor costs’ for the purposes of the guidance in paragraph 7.3.190 in that manner. [ASU 2018-20.BC14]

In the background example, this means that LE should account for SE’s variable rent payments to Landowner on a gross basis – i.e. separately recognizing variable lease cost and variable sublease income. This is regardless of whether SE reports the amount of the payments to LE; if SE does not do so, LE must estimate the amount of the payments.

Changing the background scenario, assume LR is providing maintenance services for the building under the head lease contract, and SE assumes LE’s head lease obligation to reimburse LR’s actual maintenance costs. Because maintenance is a non-lease service, the guidance in paragraph 7.3.190 does not apply. LE should account for SE’s variable maintenance payments to LR on a gross basis – i.e. separately recognizing non-lease maintenance cost and non-lease maintenance revenue. Consistent with the preceding paragraph, this is regardless of whether SE reports the amount of the maintenance payments to LE; if SE does not do so, LE must estimate their amount.



## Question 7.3.60

**Assessing whether a tax is a lessee or lessor cost****How does a lessor determine whether a tax is a lessee or a lessor cost?**

**Background:** Lessees may operate lessor assets (such as railcars or trucks) in numerous jurisdictions. The primary obligor of property or other taxes on those assets can vary by jurisdiction – e.g. the primary obligor for property or other taxes in one US state may be the lessor, while in another US state it may be the lessee. It can also vary for other reasons such as the type of leased asset. This can add complexity to determining whether the lessee's payment of property and other taxes is payment of a lessor cost (which therefore should be included in lease or variable lease income).

Before ASU 2018-20 was issued, enacting the guidance in paragraphs 7.3.180 – 7.3.190, Topic 842 required a lessor to evaluate whether it was the primary obligor for each type of tax in each taxing jurisdiction (e.g. each state, county or city). This was required to determine whether the tax was a lessee or a lessor cost, and therefore whether the tax and the lessee's payment thereof should be presented net or gross.

**Interpretive response:** After the issuance of ASU 2018-20, lessors will no longer determine whether a tax is a lessee or a lessor cost based on who is the primary obligor of the tax.

Instead, the following will apply regardless of who is the primary obligor of the tax.

- If the lessee remits payment for the tax to the taxing authority (e.g. pays the property tax on a leased property directly to the relevant city, county or town), the lessor will account for the tax as a cost of the lessee.
- If the lessor remits payment for the tax to the taxing authority, the lessor will account for the tax as its own cost.

As an exception, the guidance in paragraphs 7.3.210 – 7.3.240 applies if the lessor elects the sales and other similar taxes practical expedient and the tax is an 'in-scope' tax.

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7.3.330 After the lease commencement date, the lessor measures the net investment in the lease by: [842-30-35-1]

- increasing the carrying amount to reflect interest income resulting from accretion of the lease receivable and the unguaranteed residual asset (and recognition of deferred selling profit, if any, for direct financing leases); and
- reducing the carrying amount to reflect lease payments received.

7.3.340 The lessor uses the effective interest method to both (1) amortize the lease receivable and (2) accrete the unguaranteed residual asset to its estimated future value at the end of the lease term.

7.3.350 A lessor only remeasures its net investment in the lease after initial measurement if the lease is modified and that modification is not accounted for as a separate contract (see section 7.6). [842-30-35-2]



### Question 7.3.70

#### Lessor reassessment of key lease estimates and judgments

### Do lessors reassess key lease estimates and judgments after lease commencement?

**Interpretive response:** Unlike lessees (see section 6.6), lessors do not reassess key lease estimates and judgments after lease commencement – e.g. lease classification, lease term, the likelihood of the lessee to exercise a purchase option, or the discount rate on sales-type and direct financing leases – unless the lease is modified and that modification is not accounted for as a separate contract (see section 7.6).



### Observation

#### No requirement for lessors to reassess key lease estimates and judgments

7.3.360 The Board decided not to subject lessors to the same reassessment requirements as lessees primarily because of its decision to substantially retain lessor accounting under legacy US GAAP in Topic 840. This simplifies lessor accounting compared to lessee accounting and may limit volatility in the lessor's financial statements. Excluding lessors from the reassessment requirements also helps to align the lessor accounting guidance in Topic 842 with the guidance in Topic 840. [ASU 2016-02.BC314]

7.3.370 However, while lessors will not reassess key lease estimates and judgments, in some cases a lessor will be required to reassess estimates of variable consideration that specifically relates to a non-lease component of the contract – i.e. variable consideration that is part of the 'consideration in the contract' (see section 4.3).

### Impairment of the net investment in the lease

7.3.380 The lessor assesses its entire net investment in the lease for impairment, and recognizes any impairment loss, in accordance with the impairment guidance for financial instruments; see chapter 16 of KPMG Handbook, [Credit impairment](#). A lessor does not separately evaluate the unguaranteed residual asset for impairment (except in accordance with paragraph 7.3.420), or review the estimated residual value of the underlying asset as lessors do under Topic 840. When estimating the loss allowance for a net investment in the lease, the lessor considers the collateral relating to the net investment in the lease. The collateral represents the cash flows that the

lessor would expect to derive from the underlying asset during the remaining lease term (e.g. from the sale or re-lease of the asset for the remainder of the lease term), including an expected lump-sum payment related to the residual value of the asset at the end of the lease term (see Question 7.3.80). [842-30-35-3, ASU 2016-02.BC311]

See Example 16.2.10 of KPMG Handbook, [Credit impairment](#), for additional information and illustrations of one potential method of estimating expected credit losses for a lease portfolio.



## Question 7.3.80

### Assessing the net investment in the lease for impairment

#### Does the lessor consider expected cash flows from the underlying asset after the end of the lease term when evaluating its net investment in a sales-type or direct financing lease for impairment?

**Background:** A lessor considers the collateral relating to the net investment in the lease when determining the loss allowance, if any, for its net investment in the lease. [842-30-35-3]

Paragraph 842-30-35-3 (as originally issued in ASU 2016-02) stated that “the collateral relating to the net investment in the lease represents the cash flows that the lessor would expect to derive from the underlying asset during the remaining lease term, which excludes the cash flows that the lessor would expect to derive from the underlying asset following the end of the lease term.” This language appeared to limit the consideration of collateral to the cash flows expected to be derived from the asset during the lease term, but excluded any cash flows expected to be derived following the lease term – e.g. from sale of the asset.

Because a lessor assesses the entire net investment in the lease for impairment, which includes any guaranteed or unguaranteed residual value of the underlying asset, not considering expected cash flows to be derived following the lease term could have resulted in impairment recognition.

**Interpretive response:** Yes. The Board amended paragraph 842-30-35-3 in ASU 2018-10 to better reflect the Board’s intent that the cash flows that can be obtained from sale or re-lease of the underlying asset following the end of the lease term *should* be considered as part of the collateral relating to the net investment in the lease when assessing the net investment for impairment. [842-30-35-3]

The unit of account for assessing impairment of the net investment in the lease is the entire net investment in the lease, inclusive of any residual asset. A lessor evaluates its entire net investment in the lease for impairment using the cash flows associated with the leased asset during and following the lease term. Those cash flows include an assumed lump-sum payment related to the residual asset at the end of the lease term (e.g. from sale of the asset at auction). [ASU 2016-02.BC311]

A lessor would determine this assumed lump-sum payment amount based on the expected cash flows associated with the residual asset following the lease term, considering the possible amounts it might realize from the residual asset based on its expected market value at the end of the lease. Even though the risk associated with the lump-sum payment for the residual asset is risk related to the end-of-lease value of the residual asset, rather than credit risk (i.e. because the lessor will typically sell the asset either for cash or only to a party that is creditworthy at the end of the lease term), a current expected loss model is used to measure the residual asset risk. This accomplishes the Board's goal of using a single impairment model for the entire net investment in the lease (despite it having a financial and nonfinancial component).

This is supported by guidance in Subtopic 326-20 (credit losses on financial instruments) that requires an entity to "recognize an allowance for credit losses on net investment in leases recognized by a lessor ... An entity should include the unguaranteed residual asset with the lease receivable, net of any deferred selling profit, if applicable (i.e. the net investment in the lease)." See chapter 16 of KPMG Handbook, **Credit impairment**. While this only applies to lessors who have adopted Subtopic 326-20, we believe the unit of account for purposes of measuring a credit impairment is the same, regardless of whether a lessor is applying Topic 310 (receivables) or Subtopic 326-20. [326-20-55-8]



## Observation

### **Assessing the entire net investment in the lease for impairment vs. assessing its components separately**

7.3.390 Although the unguaranteed residual asset does not meet the definition of a financial asset, the Board thought it would be complex and provide little benefit to financial statement users to require entities to separately assess the components of the net investment for impairment – i.e. assess the lease receivable in accordance with the financial instruments impairment guidance and the unguaranteed residual asset in accordance with long-lived assets impairment guidance. [IASU 2016-02.BC310]

7.3.400 Additionally, to be classified as a sales-type lease or a direct financing lease, the unguaranteed residual asset will generally be small compared to the lease receivable. Or, in some cases, there may be no unguaranteed residual asset at all – e.g. if the lease is classified as a sales-type lease because it transfers ownership of the underlying asset to the lessee, or grants the lessee a purchase option that the lessee is reasonably certain to exercise.

7.3.410 Because most of the net investment in the lease will comprise the lease receivable (i.e. a financial asset), it was deemed appropriate for a lessor to assess the entire net investment in the lease for impairment based on the financial instruments impairment guidance. [IASU 2016-02.BC311]

## **Sale of the lease receivable**

7.3.420 If the lessor sells all, or substantially all, of the lease receivable and retains an interest in the unguaranteed residual asset, the lessor no longer

accrues the unguaranteed residual asset to its estimated future value over the lease term. The lessor reports any remaining unguaranteed residual asset at its carrying amount at the date of the sale of the lease receivable, and applies Topic 360 (property, plant and equipment) to determine whether the unguaranteed residual asset is impaired. If the lessor retains more than an insignificant portion of the lease receivable, it will continue to accrete the unguaranteed residual asset. [842-30-35-4]

7.3.425 The sale of a sales-type or direct financing lease receivable is accounted for under Topic 860 (transfers and servicing). [860-10-55-6, ASU 2016-02.BC317]

### ***Accounting for the underlying asset at the end of the lease term***

7.3.430 At the end of the lease term, the lessor reclassifies the net investment in the lease to the appropriate asset category in accordance with other US GAAP, measured at the carrying amount of the net investment in the lease. The lessor accounts for the underlying asset in accordance with other US GAAP. [842-30-35-5]

### ***Accounting for lease terminations***

7.3.440 If a sales-type or direct financing lease is terminated before the end of the lease term, the lessor:

- tests the net investment in the lease for impairment under Topic 310 (before the lessor adopts Subtopic 326-20) or Subtopic 326-20 – see chapter 16 of KPMG Handbook, *Credit impairment*;
- reclassifies the net investment in the lease to the appropriate asset category in accordance with other US GAAP, measured at the sum of the carrying amount of the lease receivable (less amounts still expected to be received by the lessor) and the residual asset; and
- accounts for the underlying asset in accordance with other US GAAP. [842-30-40-2]

7.3.450 If a lease agreement is replaced by a new lease agreement with a new lessee, the lessor accounts for the termination of the original lease (see paragraph 7.3.440) and accounts for the new lease in the same manner as it would any other new lease.



#### **Example 7.3.40**

#### **Recognition of selling profit for a direct financing lease**

This example is a continuation of Example 7.3.10, which looked at the initial measurement of the lease.

**End of Year 1**

Lessor LR records the following journal entry at the end of Year 1.

	Debit	Credit
Cash	10,500	
Unguaranteed residual asset <sup>1</sup>		95
Deferred profit <sup>2</sup>		1,657
Lease receivable <sup>3</sup>		9,301
Interest income <sup>4</sup>		2,951
<i>To recognize interest, accretion and deferred selling profit in Year 1.</i>		
Notes:		
1. Accretion of unguaranteed residual asset ( $\$3,006 \times 3.15\%$ ).		
2. Total lease income of \$2,951 (\$37,000 net investment in the lease $\times 7.98\%$ ) – interest on lease receivable (\$1,199) – accretion of unguaranteed residual asset (\$95). 7.98% is the discount rate that would have been required at lease commencement for the lease receivable + the unguaranteed residual asset to equal \$37,000.		
3. Cash payment of \$10,500 – interest on lease receivable of \$1,199 ( $\$37,994 \times 3.15\%$ ).		
4. Accretion of unguaranteed residual asset (\$95) + interest on lease receivable (\$1,199) + release of deferred profit (\$1,657). Alternative calculation: $\$37,000 \times 7.98\%$ .		

**Impact on the financial statements**

The following table summarizes the amounts arising on LR's balance sheet (on which LR presents its net investment in the lease, rather than the components in the table) and income statement.

End of year	Balance sheet				Income statement			
	Lease receivable	Unguar. resid. asset	Deferred profit <sup>1</sup>	Net invest. in lease	Interest on receivable <sup>2</sup>	Residual accretion <sup>2</sup>	Earned profit <sup>3</sup>	Total income <sup>3</sup>
0	\$37,994	\$3,006	(\$4,000)	\$37,000	\$ -	\$ -	\$ -	\$ -
1	28,693	3,101	(2,343)	29,451	1,199	95	1,657	2,951
2	19,098	3,199	(996)	21,301	905	98	1,347	2,350
3	9,200	3,300	-	12,500	602	101	996	1,699
	<b>Totals</b>				<b>\$2,706</b>	<b>\$294</b>	<b>\$4,000</b>	<b>\$7,000</b>

Notes:

- Subsequent to lease commencement, deferred selling profit recognition = total income – interest on the lease receivable – unguaranteed residual asset accretion.
- Interest on the lease receivable and unguaranteed residual asset accretion are calculated using the rate implicit in the lease that is derived by using the machine's fair value at lease commencement of \$40,000 less deferred initial direct costs of \$1,000 as the initial investment (3.15%).
- Total income, including release of deferred profit, is allocated so that it is recognized at a constant rate equal to the discount rate that would have been necessary at lease commencement for the lease receivable + the unguaranteed residual asset to equal \$37,000 (7.98%).

**End of lease**

LR records the following journal entry at the end of the lease.

	<i>Debit</i>	<i>Credit</i>
PP&E – machine	12,500	
Net investment in the lease		12,500
<i>To recognize termination of direct financing lease.</i>		



## Comparison to legacy US GAAP

### **The concept of deferred selling profit did not exist under Topic 840**

7.3.460 Under Topic 840, any selling profit in a lease that met one of the criteria in paragraph 840-10-25-1 and both criteria in paragraph 840-10-25-42 was recognized at lease commencement. Selling profit was never deferred as it will be for a direct financing lease under Topic 842.

### **The population of initial direct costs is changed, but the accounting is unchanged**

7.3.470 Section 5.5 discusses that Topic 842 substantially narrowed the definition of initial direct costs from the definition in Topic 840. As a result, many entities will expense significant origination costs for a lease as incurred that they did not expense as incurred under Topic 840. Lessors in that situation will recognize greater margins on their lease income earned over the lease term (e.g. operating lease income or interest income on their direct financing leases) as well as potentially on selling profit earned at lease commencement. That is, if a sales-type lessor incurred origination costs that were expensed at lease commencement under Topic 840 – at the same time selling profit was recognized – but expenses those origination costs as incurred under Topic 842, the lessor's commencement date selling profit under Topic 842 will not be reduced by any deferred initial direct costs. [\[842 Glossary\]](#)

7.3.480 The accounting for those costs that meet the definition of initial direct costs under Topic 842 is substantially consistent with the accounting for those costs that met the definition of initial direct costs under Topic 840 (see paragraph 7.3.60).

However, there is a mechanical difference in the accounting.

- Under Topic 840, initial direct costs for direct financing leases were recognized as an asset and that asset was amortized to income together with unearned income so as to produce a constant periodic rate of return on the net investment in the lease using the effective interest method. [\[840-30-30-11\]](#)
- Under Topic 842, the rate implicit in the lease is such that initial direct costs eligible for deferral are included automatically in the net investment in the lease; there is no need to add them separately (see paragraph 7.3.60).

7.3.490 The result is that the rate implicit in the lease is the same as the constant periodic rate of return on the net investment in the lease under Topic 840. Although the accounting for initial direct costs under Topic 842 is mechanically different from Topic 840 for those costs that meet the definition of initial direct costs, those changed mechanics will not affect total assets or periodic net income.

7.3.500 Lessor accounting for initial direct costs for operating leases is consistent with Topic 840 – i.e. recognize initial direct costs as a separate asset and amortize to expense over the lease term on the same basis as lease income (see paragraphs 7.4.10 – 7.4.20). [840-20-25-16, 35-2]

#### **Recognition of variable lease payments remains substantially unchanged**

7.3.510 Under Topic 842, variable lease payments are recognized as income by the lessor in the income statement in the period in which the changes in facts and circumstances on which those payments are based occur. This is consistent with the recognition requirements in legacy US GAAP for contingent rent. SEC guidance stipulated that contingent rental income should be accrued (i.e. it should be recognized as income) when the changes in the factor(s) on which the contingent lease payments was (were) based actually occurred.  
[SAB Topic 13, 605-10-S99-1]

## 7.4 Operating leases

### 7.4.1 Initial recognition and measurement



#### **Excerpt from ASC 842-30**

##### **25 Recognition**

###### **General**

> Operating Leases

**25-10** At the commencement date, a lessor shall defer initial direct costs.

##### **30 Initial Measurement**

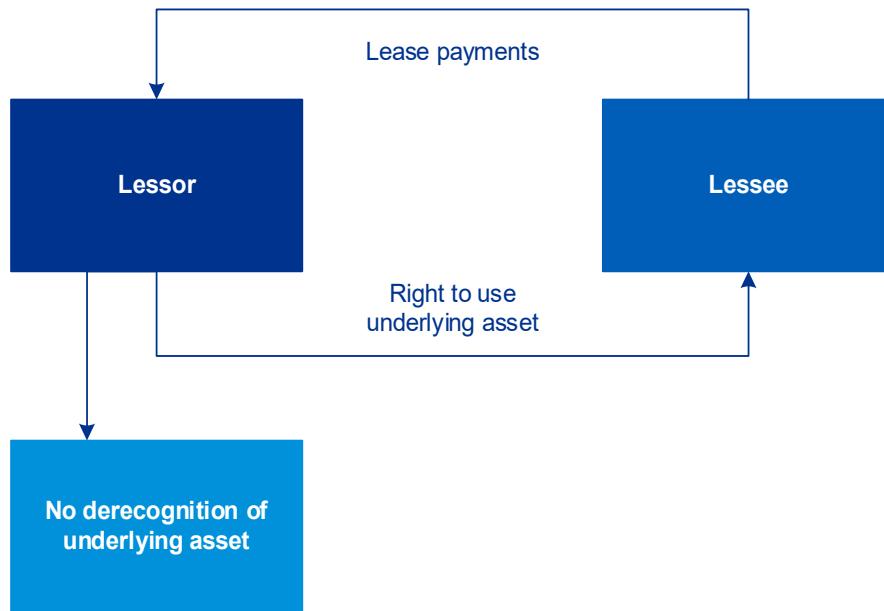
###### **General**

> Operating Leases

**30-4** A lessor shall continue to measure the **underlying asset** subject to an **operating lease** in accordance with other Topics.

7.4.10 For operating leases, at the commencement date the lessor:

- continues to recognize the underlying asset and will continue to depreciate it over its estimated useful life; [842-30-30-4]
- continues to measure the underlying asset in accordance with other US GAAP, including testing for impairment in accordance with the guidance on impairment or disposal of long-lived assets; and [842-30-35-6]
- defers any initial direct costs. [842-30-25-10]



## 7.4.2 Subsequent accounting



### Excerpt from ASC 842-30

#### 25 Recognition

##### General

> Operating Leases

**25-11** After the commencement date, a lessor shall recognize all of the following:

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

#### 35 Subsequent Measurement

##### General

> Operating Leases

**35-6** A **lessor** shall continue to measure, including testing for impairment in accordance with Section 360-10-35 on impairment or disposal of long-lived assets, the **underlying asset** subject to an **operating lease** in accordance with other Topics.

**General**

> Implementation Guidance

• > Sales of Equipment with Guaranteed Minimum Resale Amount

**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.

**55-10** At the time the purchaser elects to exercise the residual value guarantee by selling the equipment to another party, the liability should be reduced by the amount, if any, paid to the purchaser. The remaining undepreciated carrying amount of the equipment and any remaining liability should be removed from the balance sheet and included in the determination of income of the period of the equipment's sale.

**55-11** Alternatively, if the purchaser exercises the residual value guarantee by selling the equipment to the manufacturer at the guaranteed price, the liability should be reduced by the amount paid to the purchaser. Any remaining liability should be included in the determination of income of the period of the exercise of the guarantee.

**55-12** The accounting for a guaranteed minimum resale value is not in the scope of Topic 815 on derivatives and hedging. In the transaction described, the embedded guarantee feature is not an embedded derivative instrument that must be accounted for separately from the lease because it does not meet the criterion in paragraph 815-15-25-1(c).

**55-13** Specifically, if freestanding, the guarantee feature would be excluded from the scope of paragraph 815-10-15-59(b) because of both of the following conditions:

- a. It is not exchange traded.
- b. The underlying on which settlement is based is the price of a nonfinancial asset of one of the parties, and that asset is not readily convertible to cash. It is assumed that the equipment is not readily convertible to cash, as that phrase is used in Topic 815.

**55-14** Paragraph 815-10-15-59(b)(2) states that the related exception applies only if the nonfinancial asset related to the underlying is owned by the party that would not benefit under the contract from an increase in the price or value of the nonfinancial asset. (In some circumstances, the exclusion in paragraph 815-10-15-63 also would apply.)

**55-15** Lastly, Topic 460 on guarantees does not affect the guarantor's accounting for the guarantee because that Topic does not apply to a guarantee for which the underlying is related to an asset of the guarantor. Because the manufacturer continues to recognize the residual value of the equipment guaranteed by the manufacturer as an asset (included in the seller-lessor's **net investment in the lease**) if recording a sales-type lease, that guarantee does not meet the characteristics in paragraph 460-10-15-4 and is, therefore, not subject to the guidance in Topic 460. Additionally, if the lease is classified as an operating lease, the manufacturer does not remove the asset from its books, and its guarantee would be a market value guarantee of its own asset. A market value guarantee of the guarantor's own asset is not within the scope of Topic 460, and the guidance in paragraphs 842-10-55-32 through 55-33 for an operating lease is not affected. As a result, the guarantor's accounting for the guarantee is unaffected by Topic 460.

- > Pattern of Benefit from Use of the Underlying Asset

**55-17** This Subtopic considers the right to control the use of the **underlying asset** as the equivalent of physical use. If the **lessee** controls the use of the underlying asset, recognition of **lease** income in accordance with paragraph 842-30-25-11(a) should not be affected by the extent to which the lessee uses the underlying asset.

7.4.20 After the commencement date: [842-10-15-40, 842-30-25-11]

- Lease payments under the contract are recorded as receivables only when they are due and payable by the lessee. Consequently, there is no interest income recognition.
- Lease income is recognized on a straight-line basis unless another systematic and rational basis is more representative of the pattern in which income is earned from the underlying asset.
- Variable lease payments are recorded as income in the income statement in the period in which the changes in facts and circumstances on which those payments are based occur.
- Variable non-lease payments are recorded as income in the income statement when the requirements of the applicable Topic (e.g. Topic 606) are met. Initial direct costs are recognized as expense over the lease term on the same basis as lease income.

7.4.22 The sale of operating lease receivables (see paragraph 7.4.20) is accounted for under Topic 860 (transfers and servicing), consistent with any other sale of a financial asset. However, the sale of future operating lease payments that do not meet the definition of a receivable – including those amounts that arise solely from the requirement in Topic 842 to recognize operating lease income on a straight-line basis but do not meet the definition of a receivable – are not subject to Topic 860. See Question 7.4.05. [860-10-15-5, 15-4(b)]

7.4.23 If the lessor sells the underlying asset to a third party, the sale is accounted for under: [606-10-15-2, 610-20-15-2]

- Topic 606 if the third party is a customer; and
- Subtopic 610-20 (other income) if the third party is not a customer.



### Question 7.4.05

#### **Sale of future operating lease payments that do not meet definition of a receivable**

**How does a lessor account for the sale of future operating lease payments that do not yet meet the definition of a receivable subject to Topic 860?**

**Background:** See paragraphs 7.3.425 and 7.4.22.

**Interpretive response:** We believe the proceeds from the sale of these payments should be treated as debt in a manner consistent with the accounting that applies to proceeds received from the sale of future revenues under Topic 470 (debt) when the seller has significant continuing involvement in the generation of the revenues. Section 3.7.30 of KPMG Handbook, [Debt and equity financing](#), provides guidance on the accounting for the sale of future revenues.

### **Gross vs. net considerations**

7.4.25 The same gross versus net considerations outlined in section 7.3.2 for lessors in sales-type or direct financing leases apply to lessors in operating leases.



### Question 7.4.10

#### **Uneven lease payments intended to compensate for expected changes in market rent**

**Should a lessor recognize lease income on a cash basis if uneven payments are intended to reflect the parties' expectations about market rental prices throughout the lease term?**

**Background:** The basis for conclusions to ASU 2016-02 could be read to suggest that a lessor can (or should) recognize lease income arising from uneven lease payments (i.e. lease payments that change during the lease term) on a cash basis if the changes in the payments are intended to reflect expected changes in the market value of the lease. [\[ASU 2016-02.BC327\]](#)

For example, a lease of real estate may have scheduled rent increases of five percent per year that are intended to reflect what the parties expect market rental prices to be in the future. In this scenario, the question is whether it is appropriate to recognize lease income each year equal to the annual lease payment.

**Interpretive response:** No. Operating lease income must be recognized 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. Changes in market rent that are expected to occur during the lease term do not reflect changes in expected *usage* of the underlying asset, and therefore are not an appropriate basis on which to deviate from straight-line income recognition. [842-30-25-11, 55-17]

In discussions, the FASB staff has confirmed that lessors should apply the authoritative guidance in paragraphs 842-30-25-11 and 55-17 and that it would not be appropriate to recognize lease income arising from uneven lease payments on a cash basis unless that attribution reflects the pattern in which the lessor expects the lessee to derive benefit from *use* of the asset.



#### Question 7.4.15

#### **Operating lease income in lease with non-consecutive period of use**

#### **Should a lessor in an operating lease with a non-consecutive period of use recognize lease income during periods the lessee does not have the right to use the underlying asset?**

**Background:** Example 5.3.40 illustrates an operating lease with a non-consecutive period of use, concluding that lease *cost* should be recognized only during the periods the lessee has the right to use the underlying asset.

**Interpretive response:** No. Operating lease income should be recognized only during the periods the lessee has the right to use the underlying asset. [842-30-25-11(a)]

For example, consider a simplified version of Example 5.3.40 (Scenario 1). A lessee leases retail store space in a shopping mall from the lessor during the holiday season (October 15 through January 15) each year for three years in a lease classified as an operating lease. In this case, the lessor should recognize operating lease income (including any variable lease income) only during October 15 through January 15 each year; no lease income should be recognized outside of that time window.



#### Question 7.4.16

#### **Single lease cost attribution – operating lease with non-consecutive period of use that is variable at lease commencement**

#### **How should a lessor recognize lease income in an operating lease with a variable number of non-consecutive use periods?**

**Background:** Assume that a sports team (lessee) enters into a lease with a stadium owner (lessor) whereby the sports team has the right to use the stadium for 41 home games per year for 10 years, plus the right to use the stadium for any home playoff games during those 10 years (up to a maximum of 16 per year).

The sports team has exclusive rights to the stadium on each game day, and the stadium owner must ensure that the stadium is available for any regular season and playoff games – i.e. the stadium owner cannot book alternative events that it cannot cancel on any date when the sports team might need it. For simplicity, assume there are no renewal or termination options for either party in the contract.

For this lease, the question arises about how much lease income should be recognized during each right of use period, given that the total number of such periods is unknown.

Question 6.4.15 addresses this question from the lessee perspective, and Question 7.4.15 explains that operating lease income should not be recognized during periods the lessee does not have the right to use the underlying asset.

**Interpretive response:** Topic 842 does not specifically address this question. Consequently, and in the absence of additional guidance in GAAP or from the SEC staff, we believe the three approaches outlined in Question 6.4.15 for lessees are also acceptable for lessors in operating lease scenarios similar to the background example.

### Question 7.4.17



#### Curtailment of the lessee's right to use the underlying asset

#### Should an operating lessor stop recognizing, or recognize reduced, operating lease revenue when the lessee's rights to use the underlying asset have been curtailed?

**Background:** Situations arise in which the lessee's ability to use, and derive its intended economic benefits from using, the underlying asset are significantly curtailed. For example, as a result of COVID-19, retail store locations in shopping centers were closed to the public such that the retailer (lessee) could not sell its goods from the location, and restaurants were precluded from seating customers in their dining rooms (i.e. limiting their operations to carry-out or delivery only). Similar circumstances may arise during periods of civil unrest or natural disasters.

The question arises as to whether it is appropriate to suspend or reduce operating lease revenue recognition during the curtailment period.

**Interpretive response:** We believe it is inappropriate to suspend or reduce operating lease revenue recognition as long as the lessee retains the right to use the underlying asset, even in a significantly curtailed manner.

The retailer in the background example cannot sell to customers from the location, but it has not vacated the space – e.g. its inventory is still stored there, and its leasehold improvements remain in place. Therefore, the retailer still retains control over the use of the space – i.e. control has not reverted to the landlord such that the landlord can use the space itself or re-lease it.

As long as the lessee retains its right to use the underlying asset, the lessor is still performing (fulfilling its obligation) under the lease, and should not suspend

its revenue recognition. And because Topic 842 equates control over the use of an underlying asset with physical use, the lessor should not change its straight-line revenue recognition pattern during the curtailment period based on any estimate of the reduced utility or economic benefits from use of the asset to the lessee. [842-20-55-3]



#### Question 7.4.20

#### Lessor accounting for reimbursements of capital replacements and repairs in an operating lease

#### When should a lessor recognize revenue from lessee reimbursements of a capital replacement/repair that is not a promise to the customer in an operating lease?

**Background:** A lessor frequently has the contractual right to pass through costs of capital replacements or repairs to its tenants. For example, if a lessor installs a new roof on its property, the tenants may be required to reimburse the lessor for those costs.

A common reimbursement structure is for tenants to reimburse the lessor consistent with the useful life of the replacement/repair and consistent with the lessee's proportionate right to use the property.

It is also common that the lessee's reimbursement obligation ends if the lease expires. In contrast, if the lessee early terminates the lease, often the lessor has the right to recover the amounts it would have obtained from the lessee related to the capital replacement/repair over the remainder of the lease term.

For example, Lessee LE leases 10% of a shopping center's available retail space for 10 years. At the beginning of Year 2, LR installs a new \$450,000 roof on the shopping center that has a 15-year useful life. Under the terms of the lease, LE will reimburse LR \$3,000 per year for the remaining 9 years of the lease term (\$27,000 total):  $(\$450,000 \text{ total cost} / 15 \text{ years}) \times 10\% \text{ occupancy}$ .

In this example (and similar scenarios), the question arises as to whether LR should recognize the entire reimbursement (\$27,000) on a discounted basis on completion of the capital replacement/repair, or instead should recognize \$3,000 each year when it has the contractual right to the payment.

**Interpretive response:** We believe the lessor should recognize the reimbursement amount to which it expects to be entitled from a lessee for capital replacements/repairs that are not promises to the customer (see Question 4.2.25) in an operating lease over the remainder of the lessee's lease term – i.e. \$3,000 per year in the background example.

This amount should not include additional reimbursements to which the lessor will be entitled if the lease term is extended. A lessor should *not* recognize the full amount of the reimbursement when the replacement/repair is completed.

Even though the capital replacement/repair is complete and the amount of the reimbursement is known, the reimbursement is not earned, and therefore should not be recognized, at that point in time. This is because Topic 842 treats operating leases as executory contracts *for lessors only*. Therefore, the lessor's

entitlement to the reimbursement amount depends on it continuing to fulfill the executory operating lease – i.e. continuing to permit the lessee to use the underlying asset.

Question 6.6.50 addresses lessee accounting for capital replacement/repair reimbursements.



### Observation

#### **Operating leases give rise to lease receivables that will not be recognized**

7.4.30 The Board concluded that all leases, including operating leases, give rise to a lease receivable for the lessor. When the lessor makes the underlying asset available for use by the lessee, the lessor has fulfilled its obligation to transfer the right to use that asset to the lessee – the lessee controls that right of use and has a liability to make lease payments. Accordingly, the lessor has a lease receivable. The lessor controls that right to payment – e.g. it can decide to sell or securitize that right. [\[IASU 2016-02.BC75\]](#)

7.4.40 In deciding not to substantially change lessor accounting (and therefore to not require lessors to recognize those lease receivables for operating leases), the Board made a cost-benefit decision that the conceptual merits for a substantial change to lessor accounting did not provide sufficient benefits to financial statement users (e.g. investors, analysts and bankers) to justify the costs to lessors of enacting that change. [\[IASU 2016-02.BC88–BC90\]](#)



### Comparison to legacy US GAAP

#### **Lessor accounting for operating leases**

7.4.50 Lessor accounting for operating leases is (in broad terms) substantially the same as operating lease accounting under Topic 840.

7.4.60 However, a difference is most likely to arise because of changes to the guidance on identifying and separating components of a contract, and allocating consideration in the contract to lease and non-lease components (see chapter 4). For example, differences in the separation and allocation guidance can affect the amount of lease and non-lease income recognized. This will result, in some cases, from lessors applying the allocation guidance in Topic 606. In addition, lessors may also see effects from applying Topic 606 to their revenue recognition for non-lease components – i.e. potentially how they recognize revenue for some services or supply arrangements that accompany the lessor's leases.

## 7.5 Collectibility



### Excerpt from ASC 842-30

#### 25 Recognition

##### General

> Sales-Type Leases

**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.

**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.

> Operating Leases

**25-12** If collectibility of the lease payments plus any amount necessary to satisfy a **residual value guarantee** (provided by the **lessee** or any other unrelated third party) is not **probable** at the commencement date, lease income shall be limited to the lesser of the income that would be recognized in accordance with paragraph 842-30-25-11(a) through (b) or the lease payments, including variable lease payments, that have been collected from the lessee.

**25-13** If the assessment of collectibility changes after the commencement date, any difference between the lease income that would have been recognized in accordance with paragraph 842-30-25-11(a) through (b) and the lease payments, including variable lease payments, that have been collected from the lessee shall be recognized as a current-period adjustment to lease income.

**25-14** See Example 1 (paragraphs 842-30-55-18 through 55-43) for an illustration of the requirements when collectibility is not probable.

## 55 Implementation Guidance and Illustrations

### General

> Illustrations

- > Illustration of Lessor Accounting
- • > Example 1—Lessor Accounting Example
- • • > Case B—Lessor Accounting—Sales-Type Lease—Collectibility of the Lease Payments Is Not Probable

**55-25** Assume the same facts and circumstances as in Case A (paragraphs 842-30-55-19 through 55-24), except that it is not probable Lessor will collect the lease payments and any amount necessary to satisfy the residual value guarantee provided by Lessee. In reaching this conclusion, the entity observes that Lessee's ability and intention to pay may be in doubt because of the following factors:

- a. Lessee intends to make the lease payments primarily from income derived from its business in which the equipment will be used (which is a business facing significant risks because of high competition in the industry and Lessee's limited experience)
- b. Lessee has limited credit history and no significant other income or assets with which to make the payments if the business is not successful.

**55-26** In accordance with paragraph 842-30-25-3, Lessor does not derecognize the equipment and does not recognize a net investment in the lease or any selling profit or selling loss. However, consistent with Case A, Lessor pays and recognizes the initial direct costs of \$2,000 as an expense at the commencement date.

**55-27** At the end of Year 1, Lessor reassesses whether it is probable it will collect the lease payments and any amount necessary to satisfy the residual value guarantee provided by Lessee and concludes that it is not probable. In addition, neither of the events in paragraph 842-30-25-3(b) has occurred. The contract has not been terminated and Lessor has not repossessed the equipment because Lessee is fulfilling the terms of the contract.

Consequently, Lessor accounts for the \$9,500 Year 1 lease payment as a deposit liability in accordance with paragraph 842-30-25-3. Lessor recognizes depreciation expense on the equipment of \$7,714 ( $\$54,000 \text{ carrying value} \div 7\text{-year useful life}$ ).

**55-28** Lessor's accounting in Years 2 and 3 is the same as in Year 1. At the end of Year 4, Lessee makes the fourth \$9,500 annual lease payment such that the deposit liability equals \$38,000. Lessor concludes that collectibility of the lease payments and any amount necessary to satisfy the residual value guarantee provided by Lessee is now probable on the basis of Lessee's payment history under the contract and the fact that Lessee has been successfully operating its business for four years. Lessor does not reassess the classification of the lease as a sales-type lease.

**55-29** Consequently, at the end of Year 4, Lessor derecognizes the equipment, which has a carrying amount of \$23,143, and recognizes a net investment in the lease of \$35,519. The net investment in the lease consists of the lease receivable (the sum of the 2 remaining annual payments of \$9,500 and the residual value guarantee of \$13,000, discounted at the rate implicit in the lease of 5.4839 percent determined at the commencement date, which equals \$29,228) and the unguaranteed residual asset (the present value of the difference between the expected residual value of \$20,000 and the residual value guarantee of \$13,000, which equals \$6,291). Lessor recognizes selling profit of \$50,376, the difference between (a) the sum of the lease receivable and the carrying amount of the deposit liability (\$29,228 lease receivable + \$38,000 in lease payments already made = \$67,228) and (b) the carrying amount of the equipment, net of the unguaranteed residual asset (\$23,143 – \$6,291 = \$16,852).

**55-30** After the end of Year 4, Lessor accounts for the remaining two years of the lease in the same manner as any other sales-type lease. Consistent with Case A, at the end of Year 6, Lessor reclassifies the net investment in the lease, then equal to the estimated residual value of the underlying asset of \$20,000, as equipment.

••• > Case D—Lessor Accounting—Collectibility Is Not Probable

**55-40** Assume the same facts and circumstances as Case C (paragraphs 842-30-55-31 through 55-39), except that collectibility of the lease payments and any amount necessary to satisfy the residual value guarantee provided by the third party is not probable and the lease payments escalate every year over the lease term. Specifically, the lease payment due at the end of Year 1 is \$7,000, and subsequent payments increase by \$1,000 every year for the remainder of the lease term. Because it is not probable that Lessor will collect the lease payments and any amount necessary to satisfy the residual value guarantee provided by the third party in accordance with paragraph 842-10-25-3, Lessor classifies the lease as an operating lease.

**55-41** Lessor continues to measure the equipment in accordance with Topic 360 on property, plant, and equipment.

**55-42** Because collectibility of the lease payments is not probable, Lessor recognizes lease income only when Lessee makes the lease payments, and in the amount of those lease payments. Therefore, Lessor only recognizes lease income of \$7,000 at the point in time Lessee makes the end of Year 1 payment for that amount.

**55-43** At the end of Year 2, Lessor concludes that collectibility of the remaining lease payments and any amount necessary to satisfy the residual value guarantee provided by the third party is probable; therefore, Lessor recognizes lease income of \$12,000. The amount of \$12,000 is the difference between lease income that would have been recognized through the end of Year 2 (\$57,000 in total lease payments ÷ 6 years = \$9,500 per year × 2 years = \$19,000) and the \$7,000 in lease income previously recognized. Collectibility of the remaining lease payments remains probable throughout the remainder of the lease term; therefore, Lessor continues to recognize lease income of \$9,500 each year.

## 7.5.1 Considering collectibility issues

### *Reassessment of lease classification*

7.5.10 A lessor does not reassess lease classification unless the lease is modified and that modification is not accounted for as a separate contract (see section 7.6). Therefore, changes in the assessment of collectibility after the commencement date do not affect the classification of the lease, regardless of whether the change is positive (i.e. collectibility becomes probable) or negative (i.e. collectibility is determined to no longer be probable). For example, a lease that was classified as an operating lease at lease commencement solely because of collectibility issues is not reclassified as a direct financing lease if collectibility subsequently becomes probable. [842-10-25-3(b)(2), 842-30-55-25 – 55-30, 55-40 – 55-43]

### *Sales-type leases*

7.5.20 The collectibility of the lease payments and any amount necessary to satisfy a lessee residual value guarantee is assessed after a lease has been classified as a sales-type lease. The collectibility assessment does not affect the classification of the lease, but it can change the accounting from that outlined in section 7.3.

7.5.30 If collectibility of the lease payments, plus any amount necessary to satisfy a lessee residual value guarantee, is not probable at the commencement date, the lessor does not derecognize the underlying asset. Instead, the lessor recognizes lease payments received, including variable lease payments, as a deposit liability until the earlier of either of the following: [842-30-25-3]

1. collectibility of the lease payments/lessee residual value guarantee becomes probable; or

2. either:

- the contract has been terminated, and the lease payments received from the lessee are nonrefundable; or
- the lessor has repossessed the underlying asset, has no further obligation under the contract to the lessee, and the lease payments received are nonrefundable.

7.5.40 At the date that criterion (1) in paragraph 7.5.30 is met, the lessor: [842-30-25-4]

- derecognizes the carrying amount of the underlying asset;
- derecognizes the carrying amount of any deposit liability;
- recognizes a net investment in the lease on the basis of the remaining lease payments and the remaining lease term, using the rate implicit in the lease determined at the lease commencement date; and
- recognizes selling profit (loss), calculated as:



7.5.50 At the date that criterion (2) in paragraph 7.5.30 is met, the lessor derecognizes the carrying amount of any deposit liability, with a corresponding amount recognized as lease income. [842-30-25-5]

7.5.60 If collectibility is subsequently assessed as probable for a sales-type lease (i.e. after it was initially assessed as not probable at lease commencement), in accounting for that lease subsequent to the collectibility reassessment, the lessor uses the rate implicit in the lease determined at the lease commencement date. [842-30-25-4(c)]

7.5.70 If collectibility is probable at the commencement date for a sales-type lease, the lessor does not reassess whether collectibility is probable after the commencement date. Subsequent changes in the credit risk of the lessee are accounted for in accordance with the impairment guidance applicable to the net investment in the lease (see paragraph 7.3.380). [842-30-25-6]

### ***Other leases***

7.5.80 If collectibility is probable at the commencement date for a direct financing lease, the lessor does not reassess whether collectibility is probable after the commencement date. Subsequent changes in the credit risk of the lessee are accounted for in accordance with the impairment guidance applicable to the net investment in the lease (see paragraph 7.3.380). [842-30-25-6]

7.5.90 If collectibility of the lease payments plus any amount necessary to satisfy a residual value guarantee (provided by the lessee or another unrelated third party) is not probable at the commencement date: [842-30-25-12]

- the lease cannot be classified as a direct financing lease (see flowchart in paragraph 7.2.50), and is therefore an operating lease; and

- cumulative lease income is limited to the lesser of (a) the income that would be recognized in accordance with the guidance applicable to all operating leases, or (b) the amount of the lease payments, including variable lease payments, that have been collected from the lessee.

7.5.100 If the assessment of collectibility changes after the commencement date, any difference between (a) and (b) in paragraph 7.5.90 is recognized as a current-period adjustment to lease income. [842-30-25-13]



### Observation

#### Collectibility guidance for sales-type leases designed to prevent structuring opportunities

7.5.110 The guidance that applies to sales-type leases when collectibility of the lease payments, plus any amounts necessary to satisfy a lessee residual value guarantee, is not probable is similar to that applied by sellers of goods under Topic 606. The lessor guidance was developed in this manner to ensure that sellers of goods cannot circumvent the collectibility guidance in Topic 606 – i.e. recognize revenue earlier than would be permitted by Topic 606 – by structuring them as sales-type leases. [ASU 2016-02.BC104]

7.5.120 In contrast, because in the Board's view operating leases and direct financing leases are not similar to sales of the underlying asset, the Board concluded that the relevant collectibility guidance did not need to align with Topic 606. Instead, the guidance is mostly consistent with the collectibility guidance in Topic 840. [ASU 2016-02.BC105]



### Question 7.5.10

#### Impact of collectibility reassessment on lessors

### How do the collectibility reassessment requirements in Topic 842 affect lessors?

**Interpretive response:** Topic 842 includes ongoing monitoring efforts for lessors with respect to collectibility. These include all of the following.

- For any lease for which collectibility of the lease payments and amounts necessary to satisfy a residual value guarantee is not probable at lease commencement, the lessor continually reassesses whether collectibility becomes probable.
- If the lease with collectibility concerns is a sales-type lease, the lessor monitors for either of the two specified events in paragraph 7.5.30 that would permit income recognition even in the absence of a conclusion that collectibility is probable.
- For operating leases only, the lessor monitors whether collectibility remains probable after lease commencement.

The following is a summary of how collectibility is assessed for different leases.

Type of lease	Collectibility probable at lease commencement?	After initial recognition
<b>Sales-type</b>	Yes	No ongoing monitoring of collectibility; perform impairment test of net investment in lease (see paragraph 7.3.380).
	No	Ongoing monitoring of collectibility.
<b>Direct financing<sup>1</sup></b>	Yes	No ongoing monitoring of collectibility; perform impairment test of net investment in lease (see paragraph 7.3.380).
<b>Operating</b>	Yes	Ongoing monitoring of collectibility.
	No	Ongoing monitoring of collectibility.

Note:

1. A lease cannot be classified as a direct financing lease if collectibility is not probable at lease commencement.

Because lessors are not required to reassess collectibility in the same way as under Topic 840, additional processes or controls may need to be implemented to monitor for changes in collectibility and/or the occurrence of events that would trigger lease income recognition in relation to sales-type leases.



## Comparison to legacy US GAAP

### Impacts of collectibility uncertainties on lessor accounting

7.5.130 The following table summarizes the effects of collectibility uncertainties on lessor accounting under Topic 842 compared with Topic 840. [840-10-25-42(a)]

Topic 840	Topic 842
<b>Sales-type lease</b>	
<ul style="list-style-type: none"> <li>— Lease classified (and accounted for) as an operating lease.</li> <li>— No restriction on cumulative lease income to lease payments (and variable lease payments) received (but applied by some in practice).</li> </ul>	<ul style="list-style-type: none"> <li>— No effect on lease classification.</li> <li>— Underlying asset not derecognized.</li> <li>— No lease income recognized; lease payments (and variable lease payments) received recognized as a deposit liability.</li> </ul>

Topic 840	Topic 842
<b>Direct financing lease</b>	
— Lease classified (and accounted for) as an operating lease.	— Lease classified (and accounted for) as an operating lease.
— No restriction on cumulative lease income to lease payments (and variable lease payments) received (but applied by some in practice).	— Cumulative lease income restricted to lease payments (and variable lease payments) received.
<b>Operating lease</b>	
— Lease classified (and accounted for) as an operating lease.	— Lease classified (and accounted for) as an operating lease.
— No restriction on cumulative lease income to lease payments (and variable lease payments) received (but applied by some in practice).	— Cumulative lease income restricted to lease payments (and variable lease payments) received.
<b>Leveraged lease</b>	
— Lease classified (and accounted for) as an operating lease.	— N/A
— No restriction on cumulative lease income to lease payments (and variable lease payments) received (but applied by some in practice).	

### Collectibility issues generally more punitive to lessors under Topic 842

7.5.140 The accounting result of collectibility issues is generally more punitive under Topic 842 than it was under Topic 840. Consider both of the following.

- The requirement to recognize nonrefundable lease payments (and variable lease payments) as a deposit liability for sales-type leases results in (1) later lease income recognition than under Topic 840 and (2) the recognition of liabilities by the lessor that were generally not recognized under Topic 840.
- The provision limiting cumulative lease income on operating leases with collectibility concerns to the lease payments (and variable lease payments) that have been received generally results, for the same operating lease, in delayed income recognition as compared with Topic 840, which did not include a similar requirement when collectibility of the minimum lease payments were not reasonably predictable.

### Reassessing collectibility

7.5.150 Topic 842 includes ongoing monitoring efforts for lessors with respect to collectibility that were not required under Topic 840. Additional lessor processes or controls may be required to monitor for changes in collectibility and/or the occurrence of events that would trigger lease income recognition in relation to sales-type leases.

## 7.5.2 Collectibility of operating lease receivables

7.5.160 Topic 842 (like Topic 840 before it) does not include guidance about the valuation of operating lease receivables.

7.5.170 Before the adoption of Topic 326 (financial instruments—credit losses), Topic 310 (receivables) directs entities to Subtopic 450-20 (loss contingencies) when assessing the impairment of receivables that are not specifically addressed by other Topics. [310-10-35-2]

7.5.180 Topic 326 supersedes the guidance in Topic 310 on the impairment of receivables, but operating lease receivables are explicitly excluded from the scope of Topic 326. [326-20-15-3(g)]



### Observation

#### Contracts with lease and non-lease components

7.5.190 The FASB decided to exclude operating lease receivables from the scope of Topic 326, while including trade receivables and contract assets arising from non-lease components subject to Topic 606 (revenue from contracts with customers) in its scope. Because many operating lease contracts include non-lease components, the FASB's decision may create operational complexity for those lessors that enter into operating lease contracts that include non-lease components.

7.5.200 Unless the lessor can account for the operating lease and any non-lease component(s) of the contract as a single component using the optional lessor practical expedient to not separate lease and non-lease components (see section 4.4.1), the receivables arising from the contract will be subject to two different credit impairment models.

7.5.210 In July 2019, the FASB staff responded to a multi-faceted technical inquiry about lessors' accounting for operating lease receivables after the adoption of Topic 842. Many aspects of the inquiry arose because of the FASB's decision to exclude operating lease receivables from the scope of the credit losses guidance in Topic 326. Questions 7.5.20 through 7.5.70 relate to this technical inquiry.



### Question 7.5.20

#### Collectibility of operating lease receivables – lease-by-lease basis

#### Does Topic 842 require lessors to assess collectibility for operating leases on a lease-by-lease basis?

**Interpretive response:** Yes. Collectibility must be assessed for each operating lease individually. While we believe this is established by the guidance in Subtopic 842-30, it was also affirmed by the FASB staff as part of their

response to the technical inquiry (see paragraph 7.5.210). [842-30-25-12 – 25-13, ASU 2016-02.BC105]



### Question 7.5.30

#### **Collectibility of operating lease receivables – ongoing reassessment**

#### **Does Topic 842 require lessors to reassess collectibility throughout the lease term?**

**Interpretive response:** Yes. Subtopic 842-30 includes guidance about accounting for changes in the assessment of collectibility for an operating lease ‘after the commencement date’. This clearly indicates that collectibility for an operating lease is an ongoing assessment throughout the lease term. The intent of the guidance in this regard was affirmed by the FASB staff as part of their response to the technical inquiry (see paragraph 7.5.210). [842-30-25-13]



### Question 7.5.40

#### **Collectibility of operating lease receivables – leases subject to constraint**

#### **Should operating lease receivables for leases subject to the collectibility constraint be fully reserved for on the lessor’s balance sheet?**

**Interpretive response:** Yes. If, at lease commencement, an operating lease is subject to the collectibility constraint, no receivables for that lease should be recognized on the lessor’s balance sheet until collectibility of substantially all of the lease payments becomes probable. A lessor may accomplish this by either not recognizing the receivables, or fully reserving for those receivables through an allowance.

If an operating lease is *not* subject to the collectibility constraint at lease commencement, but becomes subject to it during the lease term, a reserve should be established for 100% of any outstanding lease receivables.



## Question 7.5.50

**Collectibility of operating lease receivables – leases not subject to constraint****Should a lessor recognize a reserve for operating lease receivables *not* of leases subject to the collectibility constraint after the adoption of Topic 842?**

**Interpretive response:** Based on the technical inquiry with the FASB staff (see paragraph 7.5.210), we believe either of the following approaches is acceptable as an accounting policy election to be applied consistently.

**Approach 1: Follow Subtopic 842-30 guidance only**

The basis for conclusions to ASU 2018-19 could be read to indicate that the Subtopic 842-30 collectibility guidance is the only guidance to apply when considering impairment of operating lease receivables. [\[ASU 2018-19 Summary, ASU 2018-19.BC14\]](#)

Consequently, operating lease receivables should be impaired (i.e. written off or reserved for) only when the lease is subject to the collectibility constraint. No 'general reserve' should be established or maintained for other operating lease receivables.

**Approach 2: Establish a general reserve based on Subtopic 450-20**

In deciding to exclude operating lease receivables from the scope of Topic 326, the FASB reiterated its intent, originally expressed in the basis for conclusions to ASU 2016-02, not to *significantly* change lessors' accounting for operating leases. [\[ASU 2016-02.BC90-BC92, ASU 2018-19.BC13\]](#)

Excluding operating lease receivables from the scope of Topic 326 was intended to be consistent with the intent not to significantly change operating lease accounting, *not* to preclude lessors from recording a general reserve for operating lease receivables *after* applying the collectibility constraint guidance in Subtopic 842-30. Therefore, the FASB staff believes it is acceptable for a lessor to recognize a reserve under Subtopic 450-20 for its operating lease receivables not subject to the collectibility constraint.

Applying Approach 2 does not affect a lessor's requirement to fully reserve for operating lease receivables subject to the collectibility constraint (see Question 7.5.40).



### Question 7.5.60

#### Collectibility of operating lease receivables – accounting for a general reserve

**If a lessor follows Approach 2 in Question 7.5.50, should the general reserve be recorded through a reduction to lease revenue or bad debt expense?**

**Interpretive response:** Based on the technical inquiry with the FASB staff (see paragraph 7.5.210), we believe either of the following approaches is acceptable as an accounting policy election to be applied consistently.

##### **Approach 1: Record changes to the reserve through lease revenue**

All changes to the balance of the general reserve (i.e. increases and decreases) established under Subtopic 450-20 are recorded through lease revenue. This approach generally results in consistency between the line items in the income statement that lessors record (1) changes to their general reserve, and (2) the effect of a lease becoming subject to, or leaving, the collectibility constraint.

##### **Approach 2: Record bad debt expense**

All changes to the balance of the *general* reserve (see Question 7.5.50) are recorded through bad debt expense. In accepting this approach, the FASB staff again cited the FASB's expressed intent not to *significantly* change lessors' accounting for operating leases, and noted that lessors have typically established, and recorded changes to, general operating lease receivable reserves through bad debt expense. [ASU 2018-19 Summary, ASU 2018-19.BC14]



### Question 7.5.70

#### Collectibility of operating lease receivables – impact of constraint on general reserve

**How should a lessor record the effect of becoming subject to the collectibility constraint after lease commencement if it maintains a general reserve?**

**Background:** For purposes of this question, consider the following example.

- Lessor LR is the lessor in an operating lease with Lessee LE that has a \$100 outstanding lease receivable balance – arising from the straight-lining of lease revenue – at the date LR concludes that collectibility of substantially all the remaining lease payments is not probable.
- LR maintains a general reserve under Subtopic 450-20 for its operating lease receivables not subject to the collectibility constraint.
- Using a systematic and rational approach, LR can determine that \$5 of the general reserve is attributable to the lease with LE. To make this determination, LR evaluates its general reserve including and excluding the lease with LE.

- LR's assessment of collectibility does not change again during the lease term.

**Interpretive response:** Based on the technical inquiry with the FASB staff (see paragraph 7.5.210), we believe any one of the following three approaches is acceptable as an accounting policy election to be applied consistently.

There is no financial reporting difference between the approaches for a lessor that follows Approach 1 to Question 7.5.60 – i.e. records all changes to its general operating lease receivable reserve through lease revenue. Therefore, this response assumes the lessor elects Approach 2 to Question 7.5.60 – i.e. records changes to its general reserve through bad debt expense.

#### **Approach 1: Record the effects on a gross basis**

The lessor first reserves for the entire outstanding balance of the receivables for the operating lease through a reduction to lease revenue. The lessor then records any necessary change to the general reserve for the effects of removing the troubled lease from the general reserve portfolio through bad debt expense. From the date of reassessment, the lessor recognizes lease revenue on a cash basis, unless the assessment of collectibility changes again before the end of the lease term.

Using the background example, at the date LR's assessment of collectibility for the lease changes, LR will recognize:

- a \$100 specific reserve for LE's outstanding receivables, offset by a \$100 current period reduction to lease revenue; and
- a \$5 reduction to the general operating lease receivable reserve, offset by a \$5 reduction to current period bad debt expense.

From the reassessment date, LR will recognize revenue on the lease equal to cash received.

#### **Approach 2: Record the effects on a net basis**

The lessor records a reduction to lease revenue that is *net* of the portion of the general reserve that can be attributed to the lease receivables that are now subject to the collectibility constraint. Consistent with Approach 1, from the date of reassessment, the lessor recognizes lease revenue on a cash basis, unless the assessment of collectibility changes again before the end of the lease term.

Using the background example, at the date LR's assessment of collectibility for the lease changes, LR will:

- reallocate the \$5 of the general reserve that can be attributed to the LE lease to a specific reserve for the LE lease; and
- recognize an additional \$95 specific reserve for the LE lease, offset by a \$95 current period reduction to lease revenue.

From the reassessment date, LR will recognize revenue on the lease equal to cash received.

### Approach 3: Consider the nature and purpose of the lessor's general reserve

Consistent with Approaches 1 and 2, from the date of reassessment, the lessor recognizes lease revenue on a cash basis, unless the assessment of collectibility changes again before the end of the lease term.

However, under this approach (in contrast to the others), a lessor may *not* record a reduction to lease revenue in the period that the lessor's assessment of collectibility changes. This would be the case if the lessor's general reserve methodology contemplates, and therefore establishes general reserves sufficient to absorb, periodic lease-specific credit impairments (like the background example). In that case, if collectibility of a lease that became subject to the collectibility constraint during the lease term subsequently becomes probable, the remainder of the specific reserve for the lease receivables should be reallocated to the general reserve. The reversal of the specific reserve arising from the collectibility constraint should not result in additional lease revenue or a reduction to bad debt expense; this is because it was originally established through an allocation from the general reserve.

Determining whether a lessor's general reserves are sufficient to absorb lease-specific credit impairments will likely involve judgment. However, we believe that if the lessor needs to significantly increase its general reserve at or shortly after a lease-specific credit impairment event – to address the risk of non-collection for its remaining population of operating leases not subject to the collectibility constraint – that would be evidence contrary to concluding that the lessor's general reserve is sufficient to absorb lease-specific credit impairments.

Using the background example, assume that LR's general reserve is determined to be sufficient to absorb the LE lease credit impairment. At the date LR's assessment of collectibility for the lease changes, LR will reallocate \$100 of the general reserve to a specific reserve for the LE lease; no reduction to lease revenue or additional bad debt expense will be recorded.

From the reassessment date, LR will recognize revenue on the lease equal to cash received.

## 7.6 Lease modifications



### Excerpt from ASC 842-10

#### 25 Recognition

##### General

> Lease Modifications

**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.

- > Lessor

**25-15** If an **operating lease** is modified and the modification is not accounted for as a separate **contract** in accordance with paragraph 842-10-25-8, the **lessor** shall account for the modification as if it were a termination of the existing **lease** and the creation of a new lease that commences on the **effective date of the modification** as follows:

- a. If the modified lease is classified as an operating lease, the lessor shall consider any prepaid or accrued lease rentals relating to the original lease as a part of the **lease payments** for the modified lease.
- b. If the modified lease is classified as a **direct financing lease** or a **sales-type lease**, the lessor shall derecognize any deferred rent liability or accrued rent asset and adjust the **selling profit or selling loss** accordingly.

**25-16** If a direct financing lease is modified and the modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8, the lessor shall account for the modified lease as follows:

- a. If the modified lease is classified as a direct financing lease, the lessor shall adjust the discount rate for the modified lease so that the initial net investment in the modified lease equals the carrying amount of the net investment in the original lease immediately before the effective date of the modification.
- b. If the modified lease is classified as a sales-type lease, the lessor shall account for the modified lease in accordance with the guidance applicable to sales-type leases in Subtopic 842-30, with the **commencement date** of the modified lease being the effective date of the modification. In calculating the selling profit or selling loss on the lease, the **fair value** of the **underlying asset** is its fair value at the effective date of the modification and its carrying amount is the carrying amount of the net investment in the original lease immediately before the effective date of the modification.

- c. If the modified lease is classified as an operating lease, the carrying amount of the underlying asset equals the net investment in the original lease immediately before the effective date of the modification.

**25-17** If a sales-type lease is modified and the modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8, the lessor shall account for the modified lease as follows:

- a. If the modified lease is classified as a sales-type or a direct financing lease, in the same manner as described in paragraph 842-10-25-16(a)
- b. If the modified lease is classified as an operating lease, in the same manner as described in paragraph 842-10-25-16(c).

**25-18** See Examples 15 through 22 (paragraphs 842-10-55-159 through 55-209) for illustrations of the requirements on **lease modifications**.

### 35 Subsequent Measurement

#### General

> Lease Term and Purchase Options

**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**.

> Subsequent Measurement of the Lease Payments

**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.

### 55 Implementation Guidance and Illustrations

#### General

> Implementation Guidance

• > Illustrations of Lease Modifications

• • > Lessor

• • • > 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 [ $\$1,257,789 \div 10 \text{ years} = \$125,779 \text{ per year}$ ] 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 ( $\$150,000 \times 5 \text{ years}$ ), net of Lessor's accrued rent asset of \$76,331, on a straight-line basis over the remaining 5-year lease term ( $\$673,669 \div 5 \text{ years} = \$134,734 \text{ per year}$ ). 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.

•••> 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.

• • • > 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.

• • • > 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 ( $\$65,240 \times 7.5\%$ ). Therefore, the carrying amount of the net investment in the lease is \$59,133 ( $\$65,240 + \$4,893 - \$11,000$ ).

• • • > Case A—Direct Financing Lease to Direct Financing Lease

**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.

•••> 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.

•••> Case C—Direct Financing Lease to Operating Lease

**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.

**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 ( $\$9,000 \times 3$  years) in lease payments on a straight-line basis over the 3-year modified lease term, as well as depreciation on the rerecognized equipment.

## 7.6.1 Overview

7.6.10 A lease modification is a change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease; for example, a change that adds or terminates the right to use one or more underlying assets or extends or shortens the contractual lease term.

[842 Glossary]



### Question 7.6.05

#### Contract modifications not in writing

##### Do contract modifications have to be in writing?

**Interpretive response:** No. Under Topic 842, a contract can be oral or implied as long as it creates enforceable rights and obligations on the contracting parties. Similarly, a modification to a contract can also be oral or implied, as long as it is enforceable. [\[842 Glossary\]](#)

An example of an implied modification is lessee construction or installation of lessor-owned improvements to the underlying asset – e.g. structural improvements to a leased building – not required by the lease contract. Even if no amendment is executed, it is implied that the lessor agreed to the lessee's actions. See Question 5.4.85 for further discussion.

Additional examples of contract modifications that may not result in or from written changes to the terms and conditions of the lease contract include the following (not exhaustive).

- Substituting the underlying asset, even if permitted or required by the contract – e.g. replacing Asset 1 with equivalent Asset 2.
- Significantly modifying or enhancing the underlying asset such that it is, in substance, a different asset – e.g. significantly enhancing the capacity and efficiency of a power-generating facility.
- Decreasing or increasing the number of assets subject to a lease agreement that does not specify the number of assets is accounted for as a lease modification. For example, a lease for a lessor's entire fleet of a particular asset is considered modified if the size (number of assets) and/or composition (some assets are replaced with other assets) of the fleet changes. See also Example 6.7.40. [\[842-10-55-17 – 55-18\]](#)
- Lessee actions of the nature described in paragraphs 7.6.80 – 7.6.90. [\[842-10-35-3\]](#)



### Question 7.6.05A

#### Contract changes only affecting variable or contingent payments

##### Does a lease contract change that affects only variable or contingent payments for the lease qualify as a lease modification?

**Background:** A lessor and lessee may modify the terms of a lease contract in a manner that *only* adds new, or changes existing, variable or contingent lease payments. Relevant examples could include adding or changing:

- a variable payment based on a percentage of the lessee's sales or the lessee's usage of the underlying asset;

- a payment that changes based on increases or decreases in the CPI; or
- a contingency in the lease contract that could change the amount of the payments the lessee will make under the lease.

In these circumstances, the 'lease payments' (see section 5.4) and/or the 'consideration in the contract' (see section 4.3) may not change, so some have questioned whether these changes are lease modifications under Topic 842.

**Interpretive response:** Yes. A lease modification is a change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease (see paragraph 7.6.10). Variable and contingent payments are part of the consideration for a lease; therefore, changes to (including the addition of) such payments change the consideration for the lease and give rise to a lease modification.



## Question 7.6.06

### Rent concessions – lessor

#### Is a rent concession a modification?

**Applicability:** This question does not apply to eligible COVID-19 related concessions of a lessor that has elected the practical expedient offered by the FASB staff specific to COVID-19 related rent concessions. If the lessor has elected the practical expedient and the rent concession in question is COVID-19 related, see KPMG Hot Topic, [FASB staff guidance on accounting for COVID-19 rent concessions](#).

**Background:** Rent concessions may be offered by lessors or negotiated by lessees when temporary circumstances arise – e.g. temporary closure or changes to operating hours due to COVID-19, civil unrest or a natural disaster.

Examples of rent concessions include (not exhaustive):

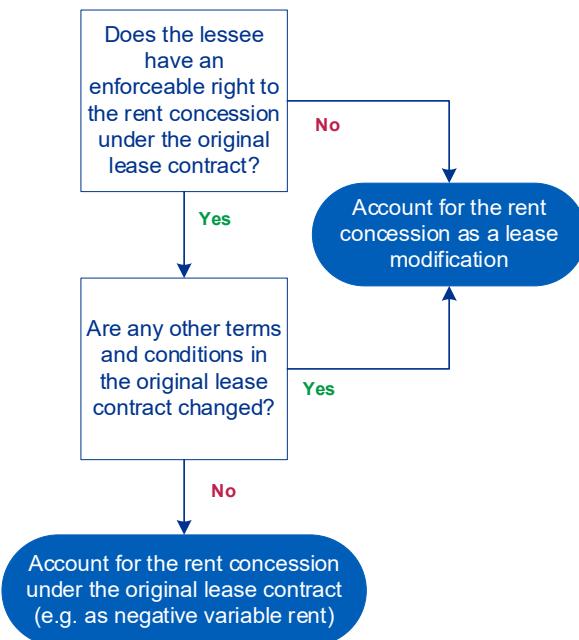
- forgiveness of contractually owed past-due rent;
- rent abatements (i.e. decreased rent payments) for future periods – e.g. 50% discount from the original rent payments for the next six months; and
- interest-free rent deferrals.

Accounting for rent concessions under Topic 842, regardless of whether proactively offered by the lessor or negotiated by the lessee, depends on the enforceable rights and obligations of the lessor under the original lease contract, and the nature of any contractual changes agreed by the parties.

**Interpretive response:** It depends. We believe the first step to answer this question is to determine whether:

- the lessee had an enforceable right to the concession before it was granted; and
- other terms and conditions of the contract that affect the scope of or consideration for the lease were changed.

The following diagram illustrates the evaluation and its result on the lessor's accounting.



### Enforceable obligation

Lease contracts may contain force majeure or similar clauses that apply in the event that unforeseen circumstances prevent the parties from fulfilling their obligations under (or obtaining their anticipated benefits from) the contract.

These clauses may provide for free, reduced or deferred rent for the period until the unforeseen circumstances are remedied, after which rent payments return to the normal amounts as specified under the original lease contract.

Alternatively, they may provide for prospective rent abatements that are intended to compensate the lessee for the effect of the unforeseen circumstances.

Even if not written into the original lease contract, the lessee may still have an enforceable right to (and the lessor may still have an enforceable obligation to grant) a rent concession based on the laws in the jurisdiction that apply to the contract – e.g. forced closure or inability of lessee to access or operate the underlying asset. Whether a force majeure or similar clause applies, or whether the lessee otherwise has an enforceable right to a rent concession, is ultimately a legal question that must be answered based on applicable law and the facts and circumstances giving rise to the evaluation.

### Changes to other terms and conditions

If the lessee has a contractual, or otherwise enforceable, right to the rent concession, there may still be a lease modification, requiring the lessor to undertake lease modification accounting. This is the case if other terms and conditions of the original lease contract affecting the scope of or consideration for the lease are changed in connection with the rent concession.

In the event of a rent concession, the two parties will be communicating, and they may take the opportunity to agree on other changes to the terms and conditions of the contract. For example, the parties may agree on a change to the lease term and/or changes to the lease payments, including variable

payment terms, not required by a force majeure clause or other enforceable rights and obligations.

In general, changes to the terms and conditions of the contract (which can be written, verbal or otherwise – see Question 7.6.05) that affect the scope of or the consideration for the lease other than merely communicating or agreeing on the amount of a rent concession for the affected periods of the lease, will trigger a lease modification. This is the case even if the impetus for the negotiation was the force majeure event.

Even if no other terms and conditions are explicitly changed, careful consideration should be given to the rent concession. If the substance of the rent concession is that it is clearly not related solely to the force majeure event, a lease modification has likely occurred. For example, the amount of the concession may be disproportionate to the effects of the force majeure event, or an additional concession might be offered to induce the lessee to extend or not terminate the lease.

### Rent deferrals – concession or not?

Agreement by the lessor to defer contractually owed lease payments or variable lease payments *is* a rent concession.

Consistent with rent forgiveness or abatement concessions, if the lessee does not have an enforceable right to the rent deferral, granting of this concession by the lessor, changing the payment terms and in effect granting the lessee an interest-free loan, is a lease modification.

### Concession required but amount uncertain

In some cases, the lessor and lessee may agree that the lessee has an enforceable right to the rent concession under the circumstances, but that the amount of the rent forgiveness or abatement, or duration of the interest-free deferral, to which the lessee is entitled, is uncertain. Neither the contract, nor the laws of the relevant jurisdiction, may clearly articulate how to determine the required concession.

For example, if a shopping center has reduced operating hours, it may be unclear how a required rent reduction should be calculated – e.g. pro rata based on the decreased number of operating hours as compared to normal, or on some other basis if the changed operating hours disproportionately affect low or high-traffic times, such as dinner hours for a restaurant in the food court.

In these cases, we believe that agreeing on the amount or duration of a contractually required concession does not in isolation trigger a lease modification. This is consistent in concept with the established practice that the two parties agreeing on the amount of a contractually required fair market rent lease payment adjustment does not constitute a lease modification.

However, a lease modification will generally still result if other terms and conditions of the lease contract affecting the scope of or consideration for the lease are changed in connection with communicating or agreeing on the amount of the rent concession (see above).

### Accounting consequences

If there is a lease modification, lessors will account for the modification consistent with any other modification.

If the lessee has an enforceable right to the rent concession for the affected period(s) and there are no other changes to the terms and conditions of the original lease contract, there is no lease modification. The lessor should continue to account for the lease under the original contract. In the case of a rent forgiveness or a rent abatement, we believe the lessor should generally account for the rent reduction as negative variable lease revenue, consistent with lessor accounting for a co-tenancy clause (see Question 7.6.10).



### Question 7.6.06A

#### Lessee short payment of rent – lessor accounting

### How does a lessor account for a lessee making rent payments that are less than the amount contractually owed (i.e. 'short payment')?

**Background:** Some lessees may decide, or be forced by their cash flow circumstances, to make rent payments that are less than the amount that is contractually owed (i.e. 'short pay').

**Interpretive response:** The first step to accounting for a short payment is to determine whether the lessee is entitled to make the short payment under the existing lease contract – i.e. whether, based on the terms and conditions of the contract, the lessee has the enforceable right to pay the lesser amount.

If so, we believe the lessor should generally account for the rent reduction as *negative* variable lease income of the period to which the short payment relates. This is consistent with how a lessor accounts for a co-tenancy clause (see Question 7.6.10).

If the enforceable rights and obligations of the lease contract do not permit the lessee to short pay the rent, the lessor will continue to account for the lease under its original terms and conditions unless and until a modification is approved. In general, this means the following.

- In an *operating* lease, lease income will continue to be based on the rental payments to which the lessor is entitled. However, an exception arises if the lessor concludes that the lessee's short payment makes it no longer probable that the lessor will collect at least substantially all of the lease payments to which it is entitled under the original contract. See section 7.5.2 for information about a lessor's accounting when this occurs. [842-30-25-13]
- In a *sales-type* or *direct financing* lease, while the lessor will continue to account for the lease under its original terms and conditions, collectibility is not reassessed under Topic 842 after the commencement date, even for significant events or changes in circumstances. Subsequent changes in the credit risk of the lessee are accounted for under the impairment guidance that applies to the net investment in the lease – i.e. Topic 326 for companies that have adopted ASU 2016-13 (credit losses), or otherwise Topic 310. [842-30-25-6, 35-3]

If a modification is approved, the lessor will apply modification accounting as illustrated throughout this section 7.6 from the 'effective date of the modification' (see paragraph 7.6.30).

**Note:** An exception to the preceding paragraph arises if the modification constitutes a concession (see Question 7.6.06) resulting from COVID-19, the concession qualifies for the FASB staff's practical expedient for COVID-19 related rent concessions and the lessor has elected the optional practical expedient to account for the concession as if it was required under the original lease contract. See KPMG Hot Topic, [FASB staff guidance on accounting for COVID-19 rent concessions](#), for guidance.



### Example 7.6.06A

#### Lessor accounting for short payments not permitted by the contract – operating lease

Lessee LE enters into a contract with Lessor LR for the right to use retail store space in a shopping mall for 12 months. The following facts are relevant.

Lease payments:	12 monthly fixed payments of \$2,000 paid in advance
Renewal options/purchase options:	None
Transfer of ownership:	No
Fair value of retail store:	\$500,000
Remaining economic life:	15 years

The lease is an operating lease; it does not meet any of the criteria to be classified as a sales-type or direct financing lease.

Due to unforeseen circumstances (not COVID-19), LE short pays Months 5 and 6. LE pays \$1,000 each month instead of the contractually required \$2,000.

LE does not have an enforceable right to short pay those months' rent and LR has not agreed to accept the reduced payments in lieu of the contractual amount owed. Therefore, LR continues to account for the lease under its original terms and conditions. LR further concludes, based on the facts and circumstances, that LE's short payment of the Months 5 and 6 payments does not call into question whether collectibility of at least substantially all of the lease payments is probable.

The contract stipulates that LE incurs a monthly 1% interest charge on any past due rent (plus accrued interest).

As a result, LR records the following journal entries in Months 5 and 6.

	Month 5		Month 6	
	Debit	Credit	Debit	Credit
Cash <sup>1</sup>	1,000		1,000	
Operating lease receivable <sup>1</sup>	1,000		1,000	
Interest receivable <sup>2,3</sup>	10		20	
Operating lease income <sup>4</sup>		2,000		2,000
Interest income		10		20

**Notes:**

1. \$2,000 contractual payment (50% paid in cash, 50% reclassified to lease receivable).
2. For Month 5: short payment of  $\$1,000 \times 1\% = \$10$ .
3. For Month 6: (Months 5 and 6 short payments (\$2,000) + Month 5 accrued interest (\$10))  $\times 1\% = \$20.10$ . [Rounded in Month 6 journal entry]
4. \$24,000 in total lease payments  $\div$  12-month lease term = \$2,000.

**Lease modification**

At the beginning of Month 7, LR agrees to forgive the unpaid portion of the Months 5 and 6 rent and interest thereon. LR concludes that the lease remains an operating lease.

As a result, LR records the following journal entry.

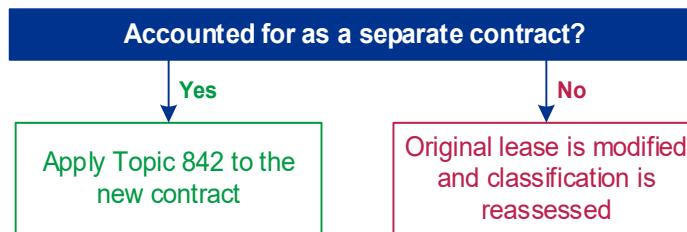
	Month 7	
	Debit	Credit
Deferred lease incentive		2,030
Interest receivable		30
Operating lease receivable		2,000

After recognizing the journal entry, LR accounts for the lease from the effective date of the modification consistent with any other modified lease.

7.6.20 A lease modification includes a change to the terms and conditions of the contract that contains the lease if that contract modification changes the ‘consideration in the contract’, and therefore changes the lease payments (see section 5.4) – i.e. changes the consideration for the lease.

7.6.30 The effective date of a lease modification is the date that the modification is approved by both the lessee and the lessor. [\[842 Glossary\]](#)

7.6.40 A key question that drives the accounting for a modification is whether the modification should be accounted for as a separate contract.



7.6.50 A modification is accounted for as a separate contract (see Example 6.7.10) when it both: [\[842-10-25-8\]](#)

- grants the lessee an additional right of use that was not included in the original contract – e.g. the right to use an additional asset; and
- the lease payments increase commensurate with the stand-alone price for the additional right of use, as adjusted for the circumstances of the particular contract.

7.6.60 An increase to the lease term (e.g. a modification changing the lease term from four to six years) does not grant the lessee an additional right of use. [842-10-25-11]



### Question 7.6.06B

#### Modifications that add a right(s) of use and make other changes

#### Can a contract modification that adds a lessee right of use, but also includes other changes, be accounted for as a separate contract?

**Background:** To illustrate, consider a scenario in which a lessee leases three floors of an office building from a lessor for an original term of five years. In Year 3, the lessor enters into an amendment with the lessee to lease it a fourth floor. In addition to the fourth floor lease, they agree to:

- extend the non-cancellable period for the three original floors to match the non-cancellable period of the new, fourth floor lease; and/or
- reduce the lease payments for the original three floors to reflect the price per square foot the lessee is paying for the fourth floor lease.

**Interpretive response:** No. A contract modification can only be accounted for as a separate contract if the only change to the existing contract is to add an additional right of use to the contract – e.g. adding another floor to an existing office space lease as in the background example. [842-10-25-8]

If changes are also made to one or more existing lease components, the separate contract guidance in paragraph 842-10-25-8 does not apply. In that case, it is not appropriate to bifurcate the additional right of use and the other changes, and assess the additional right of use separately under the separate contract guidance. [ASU 2016-02.BC171-BC172]

7.6.70 If a lease is modified and that modification is not accounted for as a separate contract, the entity reassesses the classification of the lease as of the effective date of the modification, based on the modified terms and conditions and the facts and circumstances as of that date – e.g. the fair value and remaining economic life of the underlying asset at that date. The accounting for lease modifications not accounted for as a separate contract depends on the classification of the modified lease. [842-10-25-9]

7.6.80 When a lessee exercises an option to extend a lease (including by electing not to exercise a termination option) or to purchase the underlying asset that the lessor previously determined the lessee was not reasonably certain to exercise, the lessor accounts for the exercise of that option as a lease modification. [842-10-35-3]

7.6.90 Likewise, if a lessee does not exercise an option the lessor previously determined the lessee was reasonably certain to exercise, the non-exercise of the option is accounted for as a lease modification. For example, if a lessee was deemed to be reasonably certain to exercise a renewal option, when it elects

not to do so, that is accounted for as a lease modification. Similarly, if a lessee exercises a termination option it was previously reasonably certain *not* to exercise, that is accounted for as a lease modification. [842-10-35-3]

7.6.95 A ‘modification’ that results from the exercise of a termination option or a purchase option is effectively one that terminates the lease. That is, a lease no longer exists once the lessee has either terminated the lease or has purchased the underlying asset.



### Question 7.6.07

#### Lessor consideration of a lessee's notice to exercise its purchase option

#### How should a lessor account for the notification that a lessee plans to exercise a purchase option that was not previously considered to be reasonably certain of exercise?

**Background:** A lessor leases an asset to a lessee under an operating lease. Assume that the lease contains an option for the lessee to purchase the underlying asset. The lessor had concluded at lease commencement that the purchase option was not reasonably certain of exercise. The lessee provides written notice in accordance with the lease agreement that it plans to exercise its option to purchase the underlying asset in six months.

**Interpretative response:** The lessor evaluates whether the lessee’s notification of its intent to exercise the purchase option creates or changes the enforceable rights and obligations of the lease arrangement. [842 Glossary, 606-10-25-10, 842-10-35-3]

- If the notification legally obligates the lessee to purchase the underlying asset, the lessor should account for the notification as a modification of the lease arrangement, using the notification date as the ‘effective date of the modification’ (see paragraph 7.6.30).
- If the notification does not legally obligate the lessee to purchase the underlying asset, there is no modification of the agreement. As a result, there is no change to the lessor’s accounting for the operating lease.

Consistent with paragraph 7.6.40, if there is a modification based on the preceding paragraph, the lessor first determines whether the modification should be accounted for as a separate contract. Because a lessee’s notification of its intent to exercise a purchase option does not grant the lessee the right to use an additional underlying asset, the modification cannot be accounted for as a separate contract (see paragraph 7.6.50). Therefore, the lessor accounts for the modification as a change to the existing lease.

Lessor accounting for lease modifications depends on the classification of the lease before and after the modification. Regardless of lease classification before the modification, the lessee’s legally enforceable notice to exercise its purchase option will result in sales-type lease classification for the modified lease by the lessor. This is because the transfer-of-ownership criterion (see ‘Part A’ tests in paragraph 7.2.30) will be met. Any required lease payments between the

notification and exercise dates and the exercise price of the purchase option will be included in the lessor's net investment in the modified lease.

Sections 7.6.2, 7.6.3 and 7.6.4 provide guidance about lessor accounting for lease modifications depending on whether the pre-modification lease was classified as operating, direct financing or sales-type, respectively.



### Example 7.6.07

#### Modification date – lessee fails to give termination notice

Lessee LE leases a building from Lessor LR for a noncancelable period of five years that commenced on January 1, 20X1. The lease automatically renews for a second five-year period starting January 1, 20X6 if LE does not notify LR of its intention to vacate the building on or before June 30, 20X5.

At lease commencement, LR appropriately concluded that LE was not reasonably certain to extend the lease beyond the noncancelable five-year period. Therefore, the lease term was five years. LR also appropriately concluded the lease was an operating lease (see section 7.2).

Through June 30, 20X5, LE does *not* notify LR of its intent to end the lease at the end of the noncancelable five-year period. No other lease modifications have occurred to that point, such that the remaining lease term is six months.

By not submitting notice to LR, LE has, as of June 30, 20X5, enforceably elected to renew the lease for the five-year renewal period (i.e. just as if LE had sent an affirmative renewal confirmation to LR). Therefore, consistent with paragraph 7.6.90, LR accounts for LE's election to renew the lease, which was not reasonably certain, as a lease modification. The 'effective date of the modification' is June 30, 20X5; therefore, it would be inappropriate for LR *not* to account for the lease modification as of June 30, 20X5 in this scenario.

Assuming the modified lease remains an operating lease, LR accounts for the lease modification in the same manner as any other operating lease modification in which the modified lease remains an operating lease (see section 7.6.2).

## 7.6.2 Operating lease modifications

7.6.100 If an operating lease is modified and the modification does not result in a separate contract, the lessor accounts for the modification as if the original lease is terminated, and a new lease commences on the effective date of the modification. [842-10-25-15]

Original Lease	Modified Lease	Requirements
Operating →	Operating	Lessor includes any prepaid or accrued lease rentals relating to the original lease in the lease payments for the modified lease.
Operating →	Sales-type or direct financing	Lessor derecognizes any deferred rent liability or accrued rent asset and adjusts the selling profit (loss) accordingly, which is deferred in the case of a direct financing lease.



### Example 7.6.08

#### Lessor operating lease modification – rent deferral

Lessor LR is a lessor of a residential building and enters into a 12-month lease with Lessee LE that runs from January 1 to December 31. Lease payments of \$100 are due on the first of each month of the lease term, and there are no other components of the contract. LR classifies the lease as an operating lease on the basis that none of the sales-type classification criteria are met and there is no third-party residual value guarantee. Collectibility of at least substantially all the lease payments is considered probable at lease commencement.

LE paid the January – March rent timely; however, LE does not make the \$100 April 1 payment. As a result, LR records a \$100 operating lease receivable on its books.

On April 30, LR and LE agree to a deferred payment plan whereby LE will repay the \$100 April rent over the period June through September 2020 (\$25 extra per month, in addition to the \$100 rent owed for each of those months). The lease remains classified by LR as an operating lease.

Assuming collectibility of substantially all the lease payments remains probable (see Section 7.5), the \$100 receivable remains recognized by LR post-modification (see paragraph 7.6.100).

The amount that LE will repay post-modification reduces the lease payments LR will receive post-modification for purposes of calculating the total lease income to recognize on a straight-line basis over the remaining 8 months of the lease term (May – December) – i.e. \$900 of lease payments for April through December less the \$100 for April equals \$800 to straight-line. Effectively, there is no change in lease revenue that will be recognized by LR each month throughout the remainder of lease from what it would have recognized pre-modification.

LR's lease revenue and lease receivable recognition for April – December of the lease will be as follows:

Month	Lease revenue (straight-line)	Lease payments received	Receivable at end of month
April	\$ 100	\$ -	\$ 100
May	100	100	100
June	100	125	75
July	100	125	50
August	100	125	25
September	100	125	-
October	100	100	-
November	100	100	-
December	100	100	-

It would not be appropriate for LR to write off the \$100 receivable against April lease revenue (resulting in no April lease revenue for this lease) and recognize the deferred April lease payment (\$100) together with the May through December rent (\$800 in total) on a straight-line basis over May through December (approximately \$112 per month).



### Question 7.6.10

#### Co-tenancy clauses – lessor

#### How should a lessor account for a co-tenancy clause that reduces the lessee's rent when it is triggered?

**Background:** Many retail leases include co-tenancy clauses that reduce the tenant's contractual rent if, for example, a key (or anchor) tenant (e.g. a department or 'big box' store) or a certain number of tenants vacate the property. Typically, these clauses stipulate that the tenant must resume paying the contractual rent either after a specified period of time or when the co-tenancy event is cured (e.g. a new anchor tenant occupies the relevant space vacated by the previous anchor tenant).

Key tenants and a minimum level of overall occupancy help to draw customer traffic to retail properties such as shopping malls. Therefore, the presence of one or more key tenants and/or a high level of overall occupancy of a retail property generally benefits all tenants within the mall and is an important consideration for a lessee when deciding where to lease a space (and how much the lessee is willing to pay in rent). Co-tenancy clauses serve to protect lessees from a potential drop in sales when a key tenant vacates its space or overall occupancy of the retail property declines.

Under an example co-tenancy clause, the lessee's fixed rental payments for a five-year retail space lease (e.g. \$1,000 per year in arrears) may convert to a

payment based solely on a percentage of the lessee's sales from the retail space (e.g. 5% of sales) for a specified period of time or until the co-tenancy event is cured. In that way, the lessee and the lessor share the risk that the co-tenancy event will adversely affect the lessee's sales from the leased retail space.

**Interpretive response:** At lease commencement, we believe the lessor's accounting for the lease should not consider the co-tenancy clause being triggered.

In the background example, the lessor would measure the lease payments at \$5,000 ( $\$1,000 \times 5$  years) – i.e. without consideration of the possibility that the lessee's ultimate payments during the lease could differ from that if the co-tenancy clause is triggered.

If the co-tenancy clause is triggered during the lease term, this would not be considered a lease modification by the lessor because: [842 Glossary, 842-10-35-3]

- there has been no change to the terms and conditions of the lease; and
- the lessee has not exercised an option to extend the lease or purchase the underlying asset it was not reasonably certain to exercise previously.

Therefore, the lease would not be remeasured. Instead, the difference between the lessee's actual payments (in the background example, based on 5% of the lessee's sales from the retail space) and the fixed payment that would have applied if the co-tenancy clause had not been triggered should be treated as negative variable rent.

Using the background example, assume the co-tenancy clause is triggered at the beginning of Year 3 and is not cured during the year. If the lessee's rent payment for the year is \$800 (\$16,000 in store sales  $\times$  5%), the lessor would recognize straight-line operating lease income of \$1,000 and *negative* variable lease income of (\$200), which would net to operating lease income of \$800 in the income statement.

#### Question 7.6.20

#### **Lessee exercise of options other than to extend the lease or purchase the underlying asset**

#### **How does a lessor account for lessee exercise of an option other than to extend the lease or purchase the underlying asset?**

**Background:** Topic 842 requires that when a lessee exercises an option to extend a lease or to purchase the underlying asset that the lessor previously determined the lessee was not reasonably certain to exercise, the lessor accounts for the exercise of that option as a lease modification (see paragraph 7.6.80). [842-10-35-3]

Topic 842 does not specifically address other lessee options that may exist in a lease contract. In an example of one such option, Lessor LR leases equipment to Lessee LE for three years. The contractual payments for the lease include a fixed (\$80/month) and a variable (per usage) element. However, LE has a

unilateral option under the contract to increase the fixed payments to \$100/month and eliminate the per usage variable fees. It can exercise this option before the start of any month to which the new payment structure would apply. LE's exercise of the option is irreversible – i.e. it cannot revert to the fixed and variable payment structure.

The question therefore arises as to LR's accounting if, at the end of Year 1, LE exercises the option such that LE will make fixed \$100/month payments for the remaining 24 months of the lease and no variable, per-usage payments.

**Interpretive response:** In the absence of specific lessor guidance around lessee options other than those to extend the lease or purchase the underlying asset, we believe it is appropriate for a lessor to analogize to that guidance. That is, we believe a lessor should account for a lessee's exercise of any unilateral lessee option not already factored into the lessor's pre-exercise lease accounting, such as illustrated in the background example, as a lease modification.

We believe this is consistent with the US GAAP principle of first looking to other authoritative GAAP that applies to the entity for similar transactions or events when there is no authoritative US GAAP guidance for the specific transaction or event in question. In this case, the guidance referred to in the background applies to all lessors, and we believe a lessee's exercise of an option such as that described in the background, albeit a different type of option, is a similar transaction or event. [105-10-05-2]

### 7.6.3 Direct financing lease modifications

7.6.110 Lessor accounting for a direct financing lease modification that does not result in a separate contract can be summarized as follows. [842-10-25-16]

Modified lease is:	
Operating lease	Carrying amount of underlying asset = Net investment in original lease immediately before effective date of modification
Sales-type lease	Account for modified lease in accordance with sales-type lease guidance in Subtopic 842-30 with effective date of modification as commencement date of lease <sup>1</sup>
Direct financing lease	Adjust discount rate so initial net investment in modified lease = Carrying amount of net investment in original lease immediately before effective date of modification

Note:

1. In calculating the selling profit (loss) on the lease (see paragraph 7.3.40):
  - the fair value of the underlying asset is its fair value at the effective date of the modification; and
  - the carrying amount of the underlying asset is the carrying amount of the net investment in the original lease immediately before the effective date of the modification.

## 7.6.4 Sales-type lease modifications

7.6.120 Lessor accounting for a sales-type lease modification that does not result in a separate contract can be summarized as follows. [842-10-25-17]

Modified lease is:	
Operating lease	Carrying amount of underlying asset = Net investment in original lease immediately before effective date of modification
Sales-type or direct financing lease	Adjust discount rate so initial net investment in modified lease = Carrying amount of net investment in original lease immediately before effective date of modification



### Example 7.6.10 Modification accounting – operating lease remains an operating lease

#### Original lease

Lessee LE enters into a four-year lease with Lessor LR to lease a new crane for use in a construction project that LE expects will take four years to complete. LR also agrees to maintain the crane throughout the lease term.

Payments:	Fixed payments of \$60,000 per year in arrears
Renewal/purchase options:	No
Transfer of ownership:	None
Fair value of crane:	\$500,000
Remaining economic life of crane:	15 years

The lease is an operating lease; it does not meet any of the criteria to be classified as a sales-type or direct financing lease.

LR is required to allocate the consideration in the contract to the separate lease and non-lease components based on each component's stand-alone selling price (see chapter 4). LR allocates the consideration in the contract as follows.

Component	Stand-alone price	Allocation	Calculation
Crane lease	\$230,000	\$220,800	$(230,000 / 250,000) \times 240,000$
Maintenance	20,000	19,200	$(20,000 / 250,000) \times 240,000$
	<b>\$250,000</b>	<b>\$240,000</b>	

Total consideration in the contract allocated to the lease component is \$220,800, and therefore the lease payments equal \$220,800. LR will recognize annual lease income of \$55,200 (\$220,800 / 4 years). LR will account for the non-lease component in accordance with Topic 606.

### Lease modification

At the beginning of Year 4, the construction project is expected to take three more years to complete, and LE and LR agree to extend the original lease by two years – i.e. the original four-year lease is extended to six years.

The additional two years were not an option when the original lease was negotiated. The modification alters LE's right to use the crane, but it does not grant LE an additional right of use (see paragraph 7.6.60). Therefore, LR does not account for the modification as a separate contract.

At the effective date of the modification (the beginning of Year 4 when LE and LR agree to the modification), the annual payments increase to \$70,000, which includes the annual maintenance services. Total consideration in the modified contract for the remainder of the lease term is now \$210,000 (\$70,000 × 3 years). The modified lease continues to be classified as an operating lease based on the remaining lease term (3 years) as compared to the remaining economic life of the crane (12 years) and the fair value of the crane (\$375,000).

For simplicity, assume that the stand-alone selling prices for a three-year lease and the related maintenance services at the beginning of Year 4 are the same as the stand-alone selling prices for the original four-year lease and the original four years of maintenance services. LR reallocates the remaining consideration in the modified contract at the effective date of the modification as follows.

Component	Stand-alone price	Allocation	Calculation
Crane lease	\$230,000	\$193,200	$(230,000 / 250,000) \times 210,000$
Maintenance	20,000	16,800	$(20,000 / 250,000) \times 210,000$
	<b>\$250,000</b>	<b>\$210,000</b>	

The remaining consideration in the contract allocated to the lease component is \$193,200, and therefore the remaining lease payments for the modified lease equal \$193,200. Consequently, LR will recognize annual lease income of \$64,400 (\$193,200 / 3 years) for the three years remaining on the lease. LR will continue to account for the non-lease component in accordance with Topic 606.



## Example 7.6.20

**Modification accounting – sales-type lease remains a sales-type lease****Original lease**

Lessee LE enters into a 15-year lease for a passenger aircraft with Lessor LR. The following facts are relevant at the commencement date.

Payments:	Fixed payments of \$1 million per year in arrears
Renewal/purchase options:	None
Transfer of ownership:	No
Fair value and carrying amount of aircraft:	\$10 million
Remaining economic life of aircraft:	17 years
Estimated future residual value:	\$2 million
Rate implicit in the lease:	6.76%

At the commencement date, the lease term is for the major part (i.e.  $\geq 75\%$ ) of the remaining economic life of the aircraft (it represents 88%). In addition, the present value of the lease payments amounts to substantially all (i.e.  $\geq 90\%$ ) of the fair value of the aircraft (it represents \$9.25 million, or 93% of the aircraft's fair value). Accordingly, the lease is classified as a sales-type lease (see flowchart in paragraph 7.2.30).

**Lease modification**

At the beginning of Year 3, LE decides to gradually phase this aircraft model out of its fleet. LE asks LR to renegotiate the terms of the lease and LR agrees to a modification. The following facts are relevant at the effective date of the modification.

Remaining lease term:	8 years
Remaining lease payments:	Fixed payments of \$1.025 million per year in arrears
Renewal/purchase options:	None
Transfer of ownership:	No
Fair value of aircraft:	\$9.35 million
Carrying amount of net investment in the lease:	\$9.33 million
Estimated future residual value:	\$5.5 million
Residual value guarantee (lessee):	\$5 million
Rate implicit in the lease:	6.94%

The present value of the lease payments, plus the present value of the guaranteed residual value, is \$9.06 million, or 97% of the fair value of the aircraft. Because the sum of (a) the present value of the lease payments and (b) the present value of the lessee residual value guarantee continues to equal or

exceed substantially all the fair value of the aircraft, the lease continues to be a sales-type lease (see diagram in 7.2.30).

On the effective date of the modification, LR carries forward the balance of the net investment in the lease from immediately before the effective date of the modification of \$9.33 million as the opening balance of the net investment in the modified lease.

To retain the same net investment in the lease even though the lease payments, the lease term and the estimated residual value have all changed, LR adjusts the discount rate for the lease from the rate implicit in the modified lease of 6.94% to 6.98%. This adjusted rate of 6.98% is used to calculate interest income on the net investment in the lease throughout the remaining term of the modified lease and will result, at the end of the modified lease term, in a net investment balance that equals the estimated residual value of the underlying asset (guaranteed + unguaranteed) of \$5.5 million.



### Example 7.6.30

#### **Modification accounting – direct financing lease becomes an operating lease**

##### **Original lease**

Lessee LE enters into a four-year lease for a piece of new, non-specialized equipment with Lessor LR. The following facts are relevant at the lease commencement date.

Lease payments:	Fixed payments of \$17,000 per year in arrears
Renewal/purchase options:	None
Transfer of ownership:	No
Fair value and carrying amount of equipment:	\$80,000
Remaining economic life of equipment:	12 years
Estimated future residual value:	\$24,000
Residual value guarantee (third party):	\$18,000
Rate implicit in the lease:	5.01%

In addition, both LE and the third-party residual value guarantor (unrelated to LR) are creditworthy counterparties.

The lease does not meet any of the criteria to be classified as a sales-type lease (see flowchart in paragraph 7.2.30). Therefore, the lease is classified as a direct financing lease because the sum of (a) the present value of the lease payments (\$60,264) and (b) the present value of the third-party residual value guarantee (\$14,802) is substantially all (94%) of the fair value of the equipment (\$75,066 / \$80,000), and collectibility of the lease payments, plus any amount from the third party necessary to satisfy the residual value guarantee, is probable.

At the lease commencement date, LR recognizes the following journal entry.

	Debit	Credit
Lease receivable	75,066	
Unguaranteed residual asset	4,934	
PP&E – equipment		80,000
<i>To recognize direct financing lease.</i>		

At the end of Year 1, LR receives a lease payment of \$17,000 from LE and recognizes interest income of \$4,009 ( $\$80,000 \times 5.01\%$ ). Therefore, the carrying amount of the net investment in the lease is \$67,009 ( $\$80,000 + \$4,009 - \$17,000$ ).

### Lease modification

At the beginning of Year 3, LE and LR agree to modify the lease to extend the term by two years – i.e. the original four-year lease is extended to six years total.

The following facts are relevant at the effective date of the modification.

Lease payments:	Fixed payments of \$17,000 per year in arrears
Renewal/purchase options:	None
Transfer of ownership:	No
Fair value of equipment:	\$65,000
Remaining economic life of equipment:	12 years
Carrying amount of net investment in the lease:	\$53,368
Estimated future residual value:	\$16,000
Residual value guarantee:	None
Rate implicit in the lease:	9.88%

The modified lease does not transfer title of the equipment to LE, and it does not meet any of the other criteria to be classified as a sales-type lease or the criteria to be classified as a direct financing lease (see flowcharts in paragraphs 7.2.30 and 7.2.50). Therefore, the modified lease is classified as an operating lease and, at the effective date of the modification, LR derecognizes the net investment in the lease, and recognizes the equipment at that amount.

	Debit	Credit
PP&E – equipment	53,368	
Net investment in the lease		53,368
<i>To recognize direct financing lease.</i>		

Because collectibility of the lease payments is still probable (i.e. LE remains a creditworthy counterparty), LR will recognize the \$68,000 ( $\$17,000 \times 4$  years) in lease payments on a straight-line basis over the four-year remaining term of the modified lease. LR will also recognize depreciation on the equipment.



## Observation

### Lessor vs. lessee modifications guidance

7.6.130 The lessee and lessor modifications guidance is not aligned either conceptually or mechanically. For example, the lessee modifications guidance is based on the view that time periods within a lease are not distinct from each other, that the lessor transfers a 'good' (i.e. an ROU asset) at lease commencement. In contrast, the lessor modifications guidance is based on the cost-benefit decision to account for most leases as executory contracts (see paragraphs 7.4.30 – 7.4.40), and therefore each period within a lease (e.g. each day, month, year) is distinct from those periods that precede it.

7.6.140 The fact that the supplier (lessor) and customer (lessee) modification models are not symmetrical is consistent with the fact that the core lessee and lessor accounting models are not symmetrical within Topic 842. Instead, the Board concluded, for both conceptual and practical reasons, that the lessor modifications guidance should be premised on the contract modifications guidance in Topic 606. [\[IASU 2016-02.BC179\]](#)



## Observation

### Lessor modifications guidance substantially aligns with new revenue standard

7.6.150 The generally prospective accounting for lessor lease modifications, including the guidance on when to account for a modification as a separate contract, is substantially aligned with the contract modifications guidance in Topic 606, which also accounts prospectively for modifications in which the remaining goods or services to be transferred after the modification are distinct from those transferred before the modification. Similarly, Topic 606 accounts for a modification that adds one or more distinct goods or services as a separate contract if the increase in the transaction price is commensurate with the stand-alone selling price for the additional distinct good(s) or service(s); see chapter 11 of KPMG Handbook, *Revenue recognition*. [\[IASU 2016-02.BC179\]](#)

7.6.160 Aligning the modifications guidance makes the accounting for modifications to contracts that include lease and non-lease components simpler than under Topic 840 in which the modification guidance was not aligned with Topic 605. [\[IASU 2016-02.BC179\]](#)



## Comparison to legacy US GAAP

### Lessor modifications guidance substantially changed

7.6.170 The Board received feedback that the lessor lease modification requirements under Topic 840 were overly complex. Topic 842 introduces more detailed, operable and understandable guidance for how a lessor should account for a lease modification, including illustrative examples, and is

substantially aligned with the contract modifications model in Topic 606. [840-10-25-51 – 25-52, 840-30-35-26 – 35-30]

#### Operating lease modifications that do not change the lease classification

7.6.180 Topic 842 modifications to an operating lease that does not (1) qualify to be accounted for as a separate contract and (2) change lease classification are accounted for in a manner substantially similar to lessor accounting for modifications of this nature under Topic 840.

## 7.7 Financial statement presentation



### Excerpt from ASC 842-30

#### 45 Other Presentation Matters

##### General

- > Sales-Type and Direct Financing Leases
  - > Statement of Financial Position

**45-1** A **lessor** shall present lease assets (that is, the aggregate of the lessor's net investment in **sales-type leases** and **direct financing leases**) separately from other assets in the statement of financial position.

**45-2 Lease** assets shall be subject to the same considerations as other assets in classification as current or noncurrent assets in a classified balance sheet.

- > Statement of Comprehensive Income

**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.

- > Statement of Cash Flows

**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.

- > Operating Leases

- > Statement of Financial Position

**45-6** A **lessor** shall present the **underlying asset** subject to an **operating lease** in accordance with other Topics.

- > Statement of Cash Flows

**45-7** In the statement of cash flows, a **lessor** shall classify cash receipts from **leases** within operating activities.



## Excerpt from ASC 942-230

### 45 Other Presentation Matters

**45-4** Entities within the scope of this Subtopic shall classify principal payments received under sales-type and direct financing leases within investing activities.

7.7.10 A lessor is required to present the following items arising from leases in the scope of Topic 842.

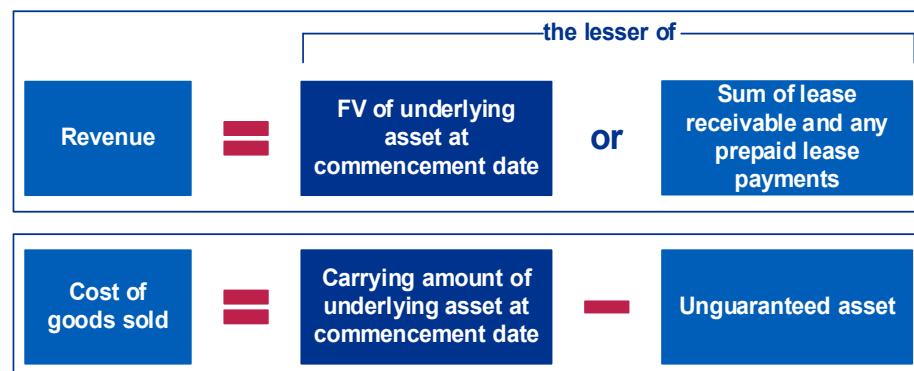
Balance sheet	
<b>Sales-type and direct financing leases</b>	Present the net investment in sales-type and direct financing leases separately from other assets. The net investment is subject to the same classification considerations as other assets on a classified balance sheet – i.e. current versus noncurrent <sup>1</sup> .
<b>Operating leases</b>	Present the underlying asset and related depreciation expense in accordance with other US GAAP (e.g. Topic 360), as applicable.
Income statement	
<b>All leases</b>	Present lease income separately or disclose the line item(s) in the income statement in which lease income is included.
<b>Sales-type and direct financing leases</b>	Present selling profit or loss recognized at lease commencement in a manner that best reflects the lessor's business model (see paragraph 7.7.20).

Statement of cash flows <sup>2</sup>	
All leases	Classify all cash receipts from leases as cash flows from operating activities. An exception applies if the lessor is a financial institution in the scope of Topic 942 and the lease is a sales-type or direct financing lease. <sup>3</sup> [842-30-45-5, 942-230-45-4]

Notes:

1. See section 12.3 for the financial statement disclosures required for the components of the total net investment in sales-type and direct financing leases – i.e. the carrying amount of lease receivables, unguaranteed residual assets and any deferred selling profit on direct financing leases.
2. For additional and more detailed guidance on lessor reporting of leases in the statement of cash flows see Chapter 14 of KPMG Handbook, [Statement of cash flows](#).
3. See Question 7.7.10.

7.7.20 If the lessor uses leases as an alternative to selling (e.g. many manufacturers and dealers), the lessor presents profit or loss at lease commencement on a gross basis as separate line items – i.e. as revenue and cost of goods sold. Revenue and cost of goods sold are recognized as follows. [842-30-45-4(a)]



7.7.30 If the lessor uses lease arrangements for the purpose of providing financing, the lessor presents profit or loss at lease commencement on a net basis in a single line item (e.g. as a gain within other income). [842-30-45-4(b)]

### Question 7.7.10

**Cash payments received for sales-type and direct financing leases**

**May a lessor classify cash payments from a lessee for a sales-type or direct financing lease as cash received from investing activities in its statement of cash flows?**

**Interpretive response:** No, unless the lessor is a financial institution in the scope of Topic 942 (financial services – depository and lending). Despite the fact that some lessors adopted that practice under Topic 840, Topic 842 is

explicit that all cash payments from leases are classified in the statement of cash flows as cash received from operating activities. [842-30-45-5, 45-7]

For financial institutions in the scope of Topic 942, the following guidance applies. [842-30-45-5, 942-230-45-4]

<b>Lease is classified as ...</b>	
<b>Sales-type or direct financing</b>	<b>Operating</b>
<ul style="list-style-type: none"> <li>— Classify the principal portion of lessee payments received as cash flows from <b>investing</b> activities.</li> <li>— Classify the interest portion of lessee payments received as cash flows from <b>operating</b> activities.</li> </ul>	<ul style="list-style-type: none"> <li>— Classify all lessee payments received as cash flows from <b>operating</b> activities.</li> </ul>



## Question 7.7.20

### Presentation and classification of initial direct costs

#### How should a lessor present initial direct costs on a classified balance sheet?

##### Interpretive response:

##### Sales-type and direct financing leases

For sales-type and direct financing leases, deferred initial direct costs are bifurcated into current and noncurrent portions because they are part of the lessor's net investment in the lease (see paragraph 7.3.60), which is required to be bifurcated (see paragraph 7.7.10). [842-30-45-2]

##### Operating leases

For an operating lease, a lessor's initial direct costs are deferred at the commencement date and recognized as an expense over the lease term on the same basis as lease income (see paragraphs 7.4.10 – 7.4.20).

Because lessors do not recognize a net investment in the lease for operating leases, initial direct costs are recognized as a separate asset on the balance sheet. Consistent with our view of costs to obtain a contract that are capitalized in accordance with Subtopic 340-40 (other assets and deferred costs – contracts with customers), we believe initial direct costs are akin to a customer relationship intangible asset and generally should be presented similarly.

Accordingly, we believe it is preferable for lessors not to bifurcate initial direct cost assets arising from operating leases into current and noncurrent portions. However, because Topic 842 does not specify whether to classify initial direct cost assets arising from operating leases for lessors, and because we have observed diversity in practice for the balance sheet presentation of contract cost assets under Subtopic 340-40, we believe such bifurcation also would be acceptable as an accounting policy election applied to all of a lessor's initial direct cost assets.



## Question 7.7.30

**Separate income statement presentation of tenant reimbursements****Is a lessor that elected the lessor non-separation practical expedient permitted to separately present tenant reimbursements in its income statement?**

**Background:** Under Topic 840, lessors (particularly real estate lessors) frequently adopted a practice for net leases (see paragraph 7.3.170) of presenting the following separately:

- revenue from the base rental payments due under a lease; and
- tenant reimbursements of lessor executory costs such as property taxes, insurance and maintenance (including common area maintenance).

Many lessors have elected (or will elect) the practical expedient to not separate lease and non-lease components (see paragraphs 4.4.51 – 4.4.57). In addition, as discussed in paragraph 7.3.190, lessors are required to recognize tenant reimbursements of lessor costs on a gross basis (i.e. as additional lease revenue). Some of these lessors have questioned whether it is acceptable under Topic 842 to continue to present the revenue from the base rental payments due under a lease separately from tenant reimbursements of lessor property tax, insurance and/or common area maintenance (CAM) costs.

**Interpretive response:** No. If a lessor has elected the non-separation practical expedient, it is not permitted to present these tenant reimbursements separately from the lease revenue related to the base rent. This is because all of the payments (base rent payments and tenant reimbursements) relate to a single lease (or non-lease – see paragraph 4.4.53) component. It would not be appropriate to separately present revenue from the two different payment streams for the same component.

However, there is one exception that might apply. As discussed in paragraph 4.4.52, a contract might contain a non-lease component that does not qualify for the non-separation practical expedient. In that case, any portion of a tenant's reimbursements appropriately allocated to that non-lease component may be recognized in an income statement line item separate from the lessor's lease revenue. For example, a portion of a variable payment for the reimbursement of lessor property taxes may – depending on the facts and circumstances – be allocated to a non-lease component such as a supply of goods that is not eligible to be combined with the lease component, and is required to be presented in an income statement line item different from where the lessor presents revenue for the lease.

Question 12.3.20 discusses a related question about the separate disclosure of tenant reimbursements.



## Question 7.7.40\*\* Presentation and classification of assets

### How should an entity classify assets it both sells and leases to customers on its balance sheet?

**Background:** To illustrate this question, consider the following scenario. Company A provides customers with devices necessary to obtain its services. Customers of Company A have the option to buy or lease the necessary device through an operating lease. Company A maintains a stock of these devices to fulfill customer orders; there is no difference between the device customers receive if they purchase it or lease it. Company A expects a meaningful population of customers will elect each option.

In this scenario, the question arises about how Company A classifies the devices on its balance sheet?

**Interpretive response:** We believe the answer to this question depends on the facts and circumstances; one size does not necessarily fit all. In the case of Company A, we believe it would be acceptable to classify the portion of its devices it expects to sell to customers as inventory and the portion it expects to lease to customers under operating leases as PP&E, following the presentation requirements in Topic 330 (and SEC Regulation S-X, as applicable) and Topic 360, respectively. Company A, in effect, has two populations of these devices, each with a different intended use, such that classifying the entire population of devices as inventory or PP&E may be misleading given Company A's expectation that it will both sell and lease significant numbers of the devices.

[Reg S-X, Article 5, Rule 5-02(6)]

Company A's methodology to allocate the devices between inventory and PP&E should be rational and systematic, and applied consistently over time and to similar circumstances.



### Comparison to legacy US GAAP

#### Cash receipts from sales-type/direct financing leases

7.7.40 Under Topic 842, a lessor (other than a financial institution in the scope of Topic 942 – see Question 7.7.10) classifies all cash receipts from leases as cash flows from operating activities. This may be a difference for some lessors that previously classified cash receipts from sales-type or direct financing leases as cash flows from investing activities.

#### Lessor presentation requirements generally consistent with Topic 840

7.7.50 In all other respects, the lessor financial statement presentation requirements in Topic 842 are substantially the same as those in Topic 840.

## 7.8 Leveraged leases



### Excerpt from ASC 842-50

#### 20 Glossary

##### Leveraged Lease

From the perspective of a **lessor**, a **lease** that was classified as a leveraged lease in accordance with the leases guidance in effect before the effective date and for which the **commencement date** is before the effective date.



### Excerpt from ASC 840-10

#### 25 Recognition

##### Lessors

> Lessor Application of Lease Classification Criteria

**25-43** If the lease at inception meets any of the four lease classification criteria in paragraph 840-10-25-1 and both of the criteria in the preceding paragraph, it shall be classified by the lessor as a sales-type lease, a direct financing lease, a leveraged lease, or an **operating lease** as follows:

- a. Sales-type lease. A lease is a sales-type lease if it gives rise to manufacturer's or dealer's profit (or loss) to the lessor (that is, the fair value of the leased property at lease inception is greater or less than its cost or carrying amount, if different) and meets either of the following conditions:
  1. It involves real estate and meets the criterion in paragraph 840-10-25-1(a) (in which circumstance, neither of the criteria in paragraph 840-10-25-42 applies).
  2. It does not involve real estate and meets any of the criteria in paragraph 840-10-25-1 and both of the criteria in paragraph 840-10-25-42.

For implementation guidance on the interaction of lease classification and lessor activities, see paragraph 840-10-55-41.

- b. Direct financing lease. A lease is a direct financing lease if it meets all of the following conditions:
  1. It meets any of the criteria in paragraph 840-10-25-1 and both of the criteria in the preceding paragraph.
  2. It does not give rise to manufacturer's or dealer's profit (or loss) to the lessor.
  3. It does not meet the criteria for a leveraged lease in (c).
- c. Leveraged lease. Leases that meet the criteria of sales-type leases set forth in (a) shall not be accounted for as leveraged leases but shall be accounted for as prescribed in paragraph 840-30-25-6. A lease is a leveraged lease if it has all of the following characteristics:

1. It meets the criteria in (b)(1) and (b)(2) for a direct financing lease.
2. It involves at least three parties: a lessee, a long-term creditor, and a lessor (commonly called the equity participant).
3. The financing provided by the long-term creditor is nonrecourse as to the general credit of the lessor (although the creditor may have recourse to the specific property leased and the unremitting rentals relating to it). The amount of the financing is sufficient to provide the lessor with substantial leverage in the transaction.
4. The lessor's net investment (see paragraph 840-30-25-8) declines during the early years once the investment has been completed and rises during the later years of the lease before its final elimination. Such decreases and increases in the net investment balance may occur more than once. ...



## Excerpt from ASC 842-50

### 25 Recognition

#### 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.

**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.

### 30 Initial Measurement

#### 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.

**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.

## 35 Subsequent Measurement

### 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.

**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.

**35-3** The net income (or loss) that a lessor recognizes on a leveraged lease shall be composed of the following three elements:

- a. Pretax lease income (or loss)
- b. Investment tax credit
- c. Tax effect of pretax lease income (or loss).

**35-4** The pretax lease income (or loss) and investment tax credit elements shall be allocated in proportionate amounts from the unearned and deferred income included in the lessor's net investment (as described in paragraph 842-50-30-1(d)). The tax effect of the pretax lease income (or loss) recognized shall be reflected in tax expense for the year. The tax effect of the difference between pretax accounting income (or loss) and taxable income (or loss) for the year shall be charged or credited to deferred taxes.

**35-5** If, at any time during the **lease term** the application of the method prescribed in this Subtopic would result in a loss being allocated to future years, that loss shall be recognized immediately. This situation might arise in circumstances in which one of the important assumptions affecting net income is revised (see paragraphs 842-50-35-6 through 35-15).

- > Changes in Assumptions

**35-6** Any **estimated residual value** and all other important assumptions affecting estimated total net income from the **leveraged lease** shall be reviewed at least annually. The rate of return and the allocation of income to positive investment years shall be recalculated from **lease inception** following the method described in paragraphs 842-50-35-2 through 35-4 and using the revised assumption if, during the **lease term**, any of the following conditions occur:

- a. The estimate of the residual value is determined to be excessive, and the decline in the residual value is judged to be other than temporary.
- b. The revision of another important assumption changes the estimated total net income from the lease.
- c. The projected timing of the income tax cash flows is revised.

**35-7** The **lessor** shall update all assumptions used to calculate total and periodic income if the lessor is performing a recalculation of the leveraged lease. That recalculation shall include actual cash flows up to the date of the recalculation and projected cash flows following the date of recalculation.

**35-8** The accounts constituting the net investment balance shall be adjusted to conform to the recalculated balances, and the change in the net investment shall be recognized as a gain or loss in the year in which the assumption is changed. The gain or loss shall be recognized as follows:

- a. The pretax gain or loss shall be included in income from continuing operations before income taxes in the same line item in which leveraged lease income is recognized.
- b. The tax effect of the gain or loss shall be included in the income tax line item.
- c. An upward adjustment of the estimated residual value (including any guaranteed portion) shall not be made.

**35-9** The projected timing of income tax cash flows generated by the leveraged lease is an important assumption and shall be reviewed annually, or more frequently, if events or changes in circumstances indicate that a change in timing has occurred or is projected to occur. The income effect of a change in the income tax rate shall be recognized in the first accounting period ending on or after the date on which the legislation effecting a rate change becomes law.

**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.

**35-20** However, an entity whose tax position frequently varies between alternative minimum tax and regular tax shall not be required to recalculate the rate of return on the leveraged lease each year unless there is an indication that the original assumptions regarding total after-tax net income from the lease are no longer valid. In that circumstance, the entity shall be required to revise the leveraged lease computations in any period in which total net income from the leveraged lease changes because of the effect of the alternative minimum tax on cash flows for the lease.

> Transfer of Minimum Rental Payments

**35-21** 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.

## 45 Other Presentation Matters

### 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.

> Income Taxes and Leveraged Leases

**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.

## 50 Disclosure

### 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.

**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.

## 55 Implementation Guidance and Illustrations

> 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.

> Illustrations

- > 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).

**55-7** This Example has the following terms and assumptions.

Cost of leased asset (equipment)	\$1,000,000
Lease term	15 years, dating from January 1, 1975

Lease rental payments	\$90,000 per year (payable last day of each year)
Residual value	\$200,000 estimated to be realized 1 year after lease termination; in the eleventh year of the lease the estimate is reduced to \$120,000
Financing:	
Equity investment by lessor	\$400,000
Long-term nonrecourse debt	\$600,000, bearing interest at 9% and repayable in annual installments (on last day of each year) of \$74,435.30
Depreciation allowable to lessor for income tax purposes	7-year asset depreciation range life using double-declining-balance method for the first 2 years (with the half-year convention election applied in the first year) and sum-of-years digits method for remaining life, depreciated to \$100,000 salvage value
Lessor's income tax rate (federal and state)	50.4% (assumed to continue in existence throughout the term of the lease)
Investment tax credit	10% of equipment cost or \$100,000 (realized by the lessor on last day of first year of lease)
Initial direct costs	For simplicity, initial direct costs have not been included in the illustration

### 55-8 Cash flow analysis by years follows.

Year	1 Gross Lease Rental and Residual Value	2 Depreciation (for Income Tax Purposes)	3 Loan Interest Payments	4 Taxable Income (Loss) (Col. 1-2-3)	5 Income Tax Credits (Charges) (Col. 4 x 50.4%)	6 Loan Principal Payments	7 Investment Tax Credit Realized	8 Annual Cash Flow (Col. 1-3 + 5-6 + 7)	9 Cumulative Cash Flow
Initial Investment								\$ (400,000)	\$ (400,000)
1	\$ 90,000	\$ 142,857	\$ 54,000	\$ (106,857)	\$ 53,856	\$ 20,435	\$ 100,000	169,421	(230,579)
2	90,000	244,898	52,161	(207,059)	104,358	22,274	-	119,923	(110,656)
3	90,000	187,075	50,156	(147,231)	74,204	24,279	-	89,769	(20,887)
4	90,000	153,061	47,971	(111,032)	55,960	26,464	-	71,525	50,638
5	90,000	119,048	45,589	(74,637)	37,617	28,846	-	53,182	103,820
6	90,000	53,061	42,993	(6,054)	3,051	31,442	-	18,616	122,436
7	90,000	-	40,163	49,837	(25,118)	34,272	-	(9,553)	112,883
8	90,000	-	37,079	52,921	(26,672)	37,357	-	(11,108)	101,775
9	90,000	-	33,717	56,283	(28,367)	40,719	-	(12,803)	88,972
10	90,000	-	30,052	59,948	(30,214)	44,383	-	(14,649)	74,323
11	90,000	-	26,058	63,942	(32,227)	48,378	-	(16,663)	57,660
12	90,000	-	21,704	68,296	(34,421)	52,732	-	(18,857)	38,803
13	90,000	-	16,957	73,043	(36,813)	57,478	-	(21,248)	17,555
14	90,000	-	11,785	78,215	(39,420)	62,651	-	(23,856)	(6,301)
15	90,000	-	6,145	83,855	(42,263)	68,290	-	(26,698)	(32,999)
16	200,000	100,000	-	100,000	(50,400)	-	-	149,600	116,601
Totals	\$ 1,550,000	\$ 1,000,000	\$ 516,530	\$ 33,470	\$ (16,869)	\$ 600,000	\$ 100,000	\$ 116,601	

### 55-9 Allocation of annual cash flow to investment and income follows.

Year	1 Lessor's Net Investment at Beginning of Year	Annual Cash Flow			Components of Income <sup>(a)</sup>		
		Total (from Col. 8 of Paragraph 842-50-55-8)	Allocated to Investment	Allocated to Income <sup>(b)</sup>	Pretax Income	Tax Effect of Pretax Income	Investment Tax Credit
1	\$ 400,000	\$ 169,421	\$ 134,833	\$ 34,588	\$ 9,929	\$ (5,004)	\$ 29,663
2	265,167	119,923	96,994	22,929	6,582	(3,317)	19,664
3	168,173	89,769	75,227	14,542	4,174	(2,104)	12,472
4	92,946	71,525	63,488	8,037	2,307	(1,163)	6,893
5	29,458	53,182	50,635	2,547	731	(368)	2,184
6	(21,177)	18,616	18,616	-	-	-	-
7	(39,793)	(9,553)	(9,553)	-	-	-	-
8	(30,240)	(11,108)	(11,108)	-	-	-	-
9	(19,132)	(12,803)	(12,803)	-	-	-	-
10	(6,329)	(14,649)	(14,649)	-	-	-	-

11	8,320	(16,663)	(17,382)	719	206	(104)	617
12	25,702	(18,857)	(21,079)	2,222	637	(321)	1,906
13	46,781	(21,248)	(25,293)	4,045	1,161	(585)	3,469
14	72,074	(23,856)	(30,088)	6,232	1,789	(902)	5,345
15	102,162	(26,698)	(35,532)	8,834	2,536	(1,278)	7,576
16	137,694	149,600	137,694	11,906	3,418	(1,723)	10,211
Totals		\$ 516,601	\$ 400,000	\$ 116,601	\$ 33,470	\$ (16,869)	\$ 100,000

- 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.

**55-10** Illustrative journal entries for the year ending December 31, 1975, follow.

Lessor's Initial Investment	Debit	Credit
Rentals receivable (table in paragraph 842-50-55-8, total of column 1 minus residual value, minus totals of columns 3 and 6)	\$ 233,470	
Investment tax credit receivable (table in paragraph 842-50-55-8, column 7)	100,000	
Estimated residual value (paragraph 842-50-55-7)	200,000	
Unearned and deferred income (table in paragraph 842-50-55-9, totals of columns 5 and 7)		\$ 133,470
Cash		400,000
Record lessor's initial investment		
First Year of Operation		
<i>Journal Entry 1</i>		
Cash	15,565	
Rental receivable (table in paragraph 842-50-55-8, column 1 minus columns 3 and 6)		15,565
Collection of first year's net rental		
<i>Journal Entry 2</i>		
Cash <sup>(a)</sup>	100,000	
Investment tax credit receivable (table in paragraph 842-50-55-8, column 7)		100,000
Receipt of investment tax credit		
<i>Journal Entry 3</i>		
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		
$(34,588 \div 116,601) \times 33,470 = 9,929$		
<i>Journal Entry 4</i>		
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		
$(34,588 \div 116,601) \times 100,000 = 29,663$		
	Debit	Credit
<i>Journal Entry 5</i>		
Cash (table in paragraph 842-50-55-8, column 5) <sup>(a)</sup>	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:		
Tax loss (table in paragraph 842-50-55-8, column 4)	\$ (106,857)	
Pretax accounting income	9,929	
Difference	<u>\$ (116,786)</u>	
Deferred taxes ( $\$116,786 \times 50.4\%$ )	\$ 58,860	

- 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					
	ASSETS		LIABILITIES		
	December 31,				
	1976	1975	1976	1975	
Investment in leveraged leases	\$ 334,708	\$ 324,027	Deferred taxes arising from leveraged leases	\$ 166,535	\$ 58,860

INCOME STATEMENT					
(Ignoring all income and expense items other than those relating to leveraged leasing)					
	1976	1975			
Income from leveraged leases	\$ 6,582	\$ 9,929			
Income before taxes and investment tax credit	6,582	9,929			
Less: Income tax expense <sup>(a)</sup>	(3,317)	(5,004)			
	3,265	4,925			
Investment tax credit recognized <sup>(a)</sup>	19,664	29,663			
Net income	\$ 22,929	\$ 34,588			

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.

	December 31,	
	1976	1975
Rentals receivable (net of principal and interest on the nonrecourse debt)	\$ 202,340	\$ 217,905
Estimated residual value of leased assets	200,000	200,000
Less: Unearned and deferred income	(67,632)	(93,878)
Investment in leveraged leases	334,708	324,027
Less: Deferred taxes arising from leveraged leases	(166,535)	(58,860)
Net investment in leveraged leases	\$ 168,173	\$ 265,167

**55-12** Allocation of annual cash flow to investment and income follows, revised to include new residual value estimate.

Year	Lessor's Net Investment at Beginning of Year	Annual Cash Flow			Components of Income		
		Total	Allocated to Investment	Allocated to Income <sup>(a)</sup>	Pretax Loss	Tax Effect of Pretax Loss	Investment Tax Credit
1	\$ 400,000	\$ 169,421	\$ 142,458	\$ 26,963	\$ (16,309)	\$ 8,220	\$ 35,052
2	257,542	119,923	102,563	17,360	(10,501)	5,293	22,568
3	154,979	89,769	79,323	10,446	(6,319)	3,184	13,581
4	75,656	71,525	66,425	5,100	(3,085)	1,555	6,630
5	9,231	53,182	52,560	622	(377)	190	809
6	(43,329)	18,616	18,616	-	-	-	-
7	(61,945)	(9,553)	(9,553)	-	-	-	-
8	(52,392)	(11,108)	(11,108)	-	-	-	-
9	(41,284)	(12,803)	(12,803)	-	-	-	-
10	(28,481)	(14,649)	(14,649)	-	-	-	-
11	(13,832)	(16,663)	(16,663)	-	-	-	-
12	2,831	(18,857)	(19,048)	191	(115)	58	248
13	21,879	(21,248)	(22,723)	1,475	(892)	450	1,917
14	44,602	(23,856)	(26,862)	3,006	(1,819)	916	3,909
15	71,464	(26,698)	(31,515)	4,817	(2,914)	1,469	6,262
16	102,979	109,920	102,979	6,941	(4,199)	2,116	9,024
Totals		\$ 476,921	\$ 400,000	\$ 76,921	\$ (46,530)	\$ 23,451	\$ 100,000

a. The revised allocation rate is 6.741%.

### 55-13 Balances in investment accounts before revised estimate of residual value follow.

	Unearned and Deferred Income						Net Investment (Col. 1+2+3) less (Col. 4+5+6)
	Rentals Receivable <sup>(a)</sup>	Estimated Residual Value	Investment Tax Credit Receivable	Pretax Income (Loss) <sup>(b)</sup>	Investment Tax Credit <sup>(c)</sup>	Deferred Taxes <sup>(d)</sup>	
Initial investment	\$ 233,470	\$ 200,000	\$ 100,000	\$ 33,470	\$ 100,000	\$ -	\$ 400,000
Changes in year of operation							
1	(15,565)	-	(100,000)	(9,929)	(29,663)	58,860	(134,833)
2	(15,565)	-	-	(6,582)	(19,664)	107,675	(96,994)
3	(15,565)	-	-	(4,174)	(12,472)	76,308	(75,227)
4	(15,565)	-	-	(2,307)	(6,893)	57,123	(63,488)
5	(15,565)	-	-	(731)	(2,184)	37,985	(50,635)
6	(15,565)	-	-	-	-	3,051	(18,616)
7	(15,565)	-	-	-	-	(25,118)	9,553
8	(15,564)	-	-	-	-	(26,672)	11,108
9	(15,564)	-	-	-	-	(28,367)	12,803
10	(15,565)	-	-	-	-	(30,214)	14,649
Balances, beginning of eleventh year	\$ 77,822	\$ 200,000	\$ -	\$ 9,747	\$ 29,124	\$ 230,631	\$ 8,320

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.

**55-14** Illustrative journal entries involving a reduction in residual value follow.

	Debit	Credit			
<i>Journal Entry 1</i>					
Pretax income (or loss)		\$ 60,314			
Unearned and deferred income		27,450			
Pretax income (loss):					
Balance at end of tenth year	\$ 9,747 <sup>(a)</sup>				
Revised balance	(9,939) <sup>(b)</sup>				
Adjustment	<u>(19,686)</u>				
Deferred investment tax credit:					
Balance at end of tenth year	29,124 <sup>(c)</sup>				
Revised balance	21,360 <sup>(d)</sup>				
Adjustment	<u>(7,764)</u>				
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)		<u>\$ 60,314</u>			
b. The cumulative and future effect of the change in allocation of the investment tax credit resulting from the reduction in estimated residual value					
	<u>30,398</u>	30,398			
<i>Journal Entry 2</i>					
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:					
Pretax accounting loss per Journal Entry 1	\$ (60,314)				
Tax income (or loss)	-				
Difference	<u>\$ (60,314)</u>				
Deferred taxes ( $\$60,314 \times 50.4\%$ )	<u>\$ (30,398)</u>				
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.					
<b>55-15</b> Adjustment of investment accounts for revised estimates of residual value follows.					
1	2	3	4	5	6
		Unearned and Deferred Income			Net Investment
	Rentals Receivable	Estimated Residual Value	Pretax Income (Loss)	Investment Tax Credit	Deferred Taxes
					(Col. 1 + 2) less (Col. 3 + 4 + 5)
Balances, beginning of eleventh year (table in paragraph 842-50-55-13)	\$ 77,822	\$ 200,000	\$ 9,747	\$ 29,124	\$ 230,631
Adjustment of estimated residual value and unearned and deferred income (table in paragraph 842-50-55-14, Journal Entry 1)	-	(80,000)	(19,686)	(7,764)	-
Adjustment of deferred taxes for the cumulative effect on pretax accounting income (table in paragraph 842-50-55-14, Journal Entry 2)	-	-	-	-	(30,398)      30,398
Adjusted balances, beginning of eleventh year	<u>\$ 77,822</u>	<u>\$ 120,000</u>	<u>\$ (9,939)</u>	<u>\$ 21,360</u>	<u>\$ 200,233</u> <u>\$ (13,832)<sup>(a)</sup></u>
a. Table in paragraph 842-50-55-12, column 1.					

• > 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
<hr/>	
Reduced by:	
Deferred investment tax credit	\$ 9,000
Deferred tax credits	39,000
	<hr/>
Net investment in leveraged lease for financial reporting	\$ 102,000
	<hr/>

**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
	<hr/>
Tax basis of leveraged lease	141,000
Temporary difference	41,000
	<hr/>
Deferred tax liability (35 percent)	\$ 100,000
	<hr/>
	\$ 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.

**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:

- Acquiring entity's cash flow analysis by years (see paragraph 842-50-55-29)
- Acquiring entity's valuation of investment in the leveraged lease (see paragraph 842-50-55-30)
- Acquiring entity's allocation of annual cash flow to investment and income (see paragraph 842-50-55-31)
- Journal entry for recording allocation of purchase price to net investment in the leveraged lease (see paragraph 842-50-55-32)
- Journal entries for the year ending December 31, 1984 (Year 10 of the lease) (see paragraph 842-50-55-33).

**55-28** This Example has the following terms and assumptions.

Cost of leased asset (equipment)	\$1,000,000
Lease term	15 years, dating from January 1, 1975
Lease rental payments	\$90,000 per year (payable last day of each year)
Residual value	\$200,000 estimated to be realized 1 year after lease termination

Financing:	
Equity investment by lessor	\$400,000
Long-term nonrecourse debt	\$600,000, bearing interest at 9% and repayable in annual installments (on last day of each year) of \$74,435.30
Depreciation allowable to lessor for income tax purposes	7-year asset depreciation range life using double-declining-balance method for the first 2 years (with the half-year convention election applied in the first year) and sum-of-years digits method for remaining life, depreciated to \$100,000 salvage value
Lessor's income tax rate (federal and state)	50.4% (assumed to continue in existence throughout the term of the lease)
Investment tax credit	10% of equipment cost or \$100,000 (realized by the lessor on last day of first year of lease)
Initial direct costs	For simplicity, initial direct costs have not been included in the illustration
Date of business combination	January 1, 1982
Tax status of business combination	Nontaxable transaction
Appropriate interest rate for valuing net-of-tax return on investment	4½%

**55-29** Acquiring entity's cash flow analysis by years follows.

Year	1 Gross Lease Rentals and Residual Value	2 Depreciation (for Income Tax Purposes)	3 Loan Interest Payments	4 Taxable Income (Col. 1 – 2 – 3)	5 Income Tax (Charges) (Col. 4 × 50.4%)	6 Loan Principal Payments	7 Annual Cash Flow (Col. 1 – 3 + 5 – 6)
8	\$ 90,000	-	\$ 37,079	\$ 52,921	\$ (26,672)	\$ 37,357	\$ (11,108)
9	90,000	-	33,717	56,283	(28,367)	40,719	(12,803)
10	90,000	-	30,052	59,948	(30,214)	44,383	(14,649)
11	90,000	-	26,058	63,942	(32,227)	48,378	(16,663)
12	90,000	-	21,704	68,296	(34,421)	52,732	(18,857)
13	90,000	-	16,957	73,043	(36,813)	57,478	(21,248)
14	90,000	-	11,785	78,215	(39,420)	62,651	(23,856)
15	90,000	-	6,145	83,855	(42,263)	68,290	(26,698)
16	200,000	\$ 100,000	-	100,000	(50,400)	-	149,600
Totals	\$ 920,000	\$ 100,000	\$ 183,497	\$ 636,503	\$ (320,797)	\$ 411,988	\$ 3,718

**55-30** Acquiring entity's valuation of investment in the leveraged lease follows.

	Cash Flow	Present Value at 4½% Net-of- Tax Rate
1.	Rentals receivable (net of principal and interest on the nonrecourse debt) (\$15,564.70 at the end of each year for 8 years)	\$ 102,663
2.	Estimated residual value (\$200,000 realizable at the end of 9 years)	134,581
3.	Future tax payments (various amounts payable over 9 years – see the table in paragraph 842-50-55-29)	(253,489)
Net present value		\$ (16,245)

**55-31** Acquiring entity's allocation of annual cash flow to investment and income follows (see footnote (a)).

Year	1 Net Investment at Beginning of Year	2 Annual Cash Flow			5 Components of Income <sup>(b)</sup>	
		2 Total from Col. 7 of the Table in Paragraph 842-50-55-29	3 Allocated to Investment	4 Allocated to Income <sup>(a)</sup>	5 Pretax Income	6 Tax Effect of Pretax Income
8	\$ (16,245)	\$ (11,108)	\$ (11,108)	-	-	-
9	(5,137)	(12,803)	(12,803)	-	-	-

10	7,666	(14,649)	(14,973)	\$ 324	\$ 5,530	\$ (5,206)
11	22,639	(16,663)	(17,621)	958	16,353	(15,395)
12	40,260	(18,857)	(20,561)	1,704	29,087	(27,383)
13	60,821	(21,248)	(23,822)	2,574	43,937	(41,363)
14	84,643	(23,856)	(27,439)	3,583	61,160	(57,577)
15	112,082	(26,698)	(31,443)	4,745	80,995	(76,250)
16	143,525	149,600	143,525	6,075	103,698	(97,623)
Totals		\$ 3,718	\$ (16,245)	\$ 19,963	\$ 340,760	\$ (320,797)

- a. Lease income is recognized as 4.233% of the unrecovered investment at the beginning of each year in which the net investment is positive. The rate is that rate which, if applied to the net investment in the years in which the net investment is positive, will distribute the net income (net cash flow) to those years.
- b. Each component is allocated among the years of positive net investment in proportion to the allocation of net income in column 4. Journal Entry 2 in 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

### 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)		
<i>Journal Entry 1</i>		
Cash		\$ 15,565
Rentals receivable (table in paragraph 842-50-55-29, column 1 minus columns 3 and 6)		\$ 15,565
Collection of year's net rental		
<i>Journal Entry 2</i>		
Unearned and deferred income		\$ 5,530
Income from leveraged leases (table in paragraph 842-50-55-31, column 5)		\$ 5,530
Recognition of pretax income for the year allocated in the same proportion as the allocation of total income computed as follows:		
$(\$324 \div \$19,963) \times \$340,760 = \$5,530$		
<i>Journal Entry 3</i>		
Deferred taxes (table in paragraph 842-50-55-29, column 5, minus table in paragraph 842-50-55-31, column 6)		\$ 25,008
Income tax expense (table in paragraph 842-50-55-31, column 6)		5,206
Cash (table in paragraph 842-50-55-29, column 5)		\$ 30,214
To record payment of tax for the year		

## 7.8.1 Overview

7.8.10 Leveraged leasing transactions typically provide significant tax and financial reporting benefits for lessors applying US GAAP. Leveraged leases usually involve capital intensive assets such as airplanes and power plants that are leased for extended periods (e.g. 25 years or more). However, these transactions have become more infrequent in recent years due to changes in interest rates and investment tax incentives.

7.8.20 Topic 842 eliminates leveraged lease accounting for leases that commence on or after the effective date. Instead, a lessor accounts for all leases as sales-type, direct financing or operating leases. Leveraged leases that

commence before the effective date of Topic 842 are not subject to its requirements (i.e. leveraged lease accounting continues) unless they are modified after the effective date of Topic 842. Leveraged leases that are modified after the effective date of Topic 842 are subject to Topic 842 at the effective date of the modification – i.e. grandfathering is terminated (see section 13.6). [842-10-65-1(z), 842-50]

7.8.30 The exercise of a renewal option by the lessee ‘that it was not previously reasonably assured to exercise’ under Topic 840 is considered a lease modification. If this occurs, the lease is no longer a leveraged lease and the lessor applies Topic 842 to the lease from the date of exercise – i.e. the lease loses its grandfathered status. [842-50-15-1]

7.8.40 The exercise of a lessee renewal option that is in the lease contract, regardless of whether the lessee was reasonably certain to exercise that option, is not considered a lease modification under any other circumstance in Topic 842.

## 7.8.2 Leveraged lease definition

7.8.50 A leveraged lease is a lease that has the following characteristics at its inception:

- the lease meets the criteria to be classified as a direct financing lease under 840-10-25-43(b);
- the lease involves at least three parties: a lessee, a long-term creditor and a lessor (commonly called the equity participant);
- the financing provided by the long-term creditor is nonrecourse as to the general credit of the lessor, and the amount of the financing is sufficient to provide the lessor with substantial leverage in the transaction; and
- the lessor’s net investment declines during the early years once the investment has been completed and rises during the later years of the lease before its final elimination – such decreases and increases in the net investment balance may occur more than once. [840-10-25-43(c)]

7.8.60 When each of these characteristics are present, the lessor accounts for the lease as a leveraged lease. Leveraged lease accounting is not relevant to the lessee involved in the lease. [842 Glossary, 840-10-25-43(c)]



### Question 7.8.10

#### Real estate leases and leases in sale-leaseback transactions

**Are real estate leases or leases in sale-leaseback transactions prohibited from being classified as leveraged leases by a lessor?**

**Interpretive response:** No. The leveraged lease criteria do not prohibit real estate leases or leases in sale-leaseback transactions from being classified as leveraged leases. [840-10-25-43(c)]



### Question 7.8.20

#### Lease of an existing asset classified as a leveraged lease

**Can a lessor that leases an asset it already owns classify the lease as a leveraged lease?**

**Interpretive response:** Generally, no. As noted at paragraph 7.8.50, to qualify for leveraged lease classification, a lease must meet the Topic 840 criteria to be classified as a direct financing lease. The cost, or carrying amount, and the fair value of the asset need to be the same at inception of the lease for it to be classified as a direct financing lease under Topic 840. [840-10-25-43(b), 25-43(b)(2)]

Although an asset already owned by a lessor that has been placed into service may have a carrying amount that is close to its fair value, in nearly all circumstances the two amounts will not be equal. As a result, classification as a direct financing lease, and thereby qualification for classification as a leveraged lease, will generally only be appropriate when the lessor purchases the asset to be leased at or near inception of the lease.

The requirement for the carrying amount and fair value of the underlying asset to be equal to qualify for direct financing lease classification no longer applies under Topic 842. However, for a leveraged lease to be grandfathered under paragraph 842-10-65-1(z), it must have met the criteria to be classified as a leveraged lease under the provisions of Topic 840 (see section 13.6).



### Question 7.8.30

#### **Requirement for a leveraged lease to involve at least three parties**

##### **Is leveraged lease classification appropriate if one entity represents two of the three required parties?**

**Background:** Paragraph 840-10-25-43(c)(2) requires a leveraged lease to involve at least three parties: a lessee, a long-term creditor, and a lessor or equity participant.

**Interpretive response:** No. If one entity serves as more than one of the three parties required by paragraph 840-10-25-43(c)(2) – e.g. the lessor is also the long-term creditor – leveraged lease classification is not appropriate.

Similarly, when related parties that are consolidated serve as two of the three parties to the lease, leveraged lease accounting is not appropriate in the consolidated financial statements. For example, if a subsidiary entered into a lease as the lessor and secured nonrecourse financing from its parent, leveraged lease accounting in the parent's consolidated financial statements would not be appropriate. However, the subsidiary may meet the criteria for leveraged lease classification in its stand-alone financial statements.



### Question 7.8.40

#### **Leveraged lease classification when there are multiple lessees and cross-collateralization**

##### **Is leveraged lease classification appropriate when a lessor leases the same type of asset to multiple unrelated lessees and finances all of the leased assets through nonrecourse debt from a single creditor with the debt collateralized by all of the leased assets?**

**Interpretive response:** No. In this situation, the leases would not meet the criteria for leveraged lease classification under paragraph 840-10-25-43(c)(3) because the debt would be recourse to multiple assets leased by multiple lessees.



### Question 7.8.50

#### Leveraged lease classification when multiple assets are leased to a single lessee

**Question 1: Is leveraged lease classification appropriate when a lessor leases multiple assets of the same type to a single lessee?**

**Question 2: If the answer to Question 1 is yes, would leveraged lease classification still be appropriate if that lessee subleased those assets to multiple unrelated sublessees?**

**Interpretive response:**

**Question 1:** Yes. In this case, the debt would be recourse only to the assets leased to the individual lessee and the criterion in paragraph 840-10-25-43(c)(3) would be satisfied. If the lease satisfied the remaining criteria in paragraph 840-10-25-43(c), leveraged lease classification would be appropriate.

**Question 2:** Maybe. In this circumstance, we believe all of the following conditions should be met for leveraged lease classification to apply.

- The lessee to the master lease agreement is clearly the principal in the transaction with the lessor and has substance of its own separate from the sublessees. This would not be the case if the lessee to the master lease agreement is only required to make lease payments to the lessor if it receives lease payments from its sublessees or is clearly otherwise unable to perform if the sublessees do not perform (e.g. is nominally capitalized). If the lessee to the master lease agreement is not clearly the principal in the transaction with the lessor or does not have substance on its own separate from the sublessees, the agreement represents a lease of multiple individual assets to multiple lessees and leveraged lease classification would not be appropriate for the same reason provided in Question 7.8.40.
- If the lessor has obtained residual value insurance for the master lease agreement to meet the criteria for direct financing lease classification, the lessor and the residual value insurer are unrelated third parties and the residual value insurance is provided at an individual leased asset level rather than an aggregate portfolio basis as required by paragraph 840-30-S99-1 (see paragraphs 842-10-55-9 – 55-10).
- It is appropriate to assess lease classification on a portfolio basis for the master lease. Generally, to qualify for portfolio basis lease classification and accounting, the assets leased as part of the master lease agreement should have similar characteristics (size and composition) and should individually meet the criteria for direct financing lease classification under paragraph 840-10-25-43(b). The lessor should also reasonably expect that the accounting for the portfolio will not differ materially from the accounting for the individual leases in that portfolio (see section 5.8).

If the above conditions are not met, leveraged lease classification would not be appropriate.



## Question 7.8.60

**Impact of nonrecourse debt on lease classification**

**Does a lessor's use of nonrecourse debt to finance the manufacture of a leased asset affect lease classification when the lease would otherwise qualify for sales-type lease classification under paragraph 840-10-25-43(a)?**

**Interpretive response:** No. Paragraph 840-10-25-43(c) states that "leases that meet the definition of sales-type leases set forth in (a) shall not be accounted for as leveraged leases but shall be accounted for as prescribed in paragraph 840-30-25-6 [which prescribes the accounting for sales-type leases]." As a result, even if a lessor finances the manufacture of a leased asset through nonrecourse debt, which is one of the criteria for leveraged lease classification, sales-type lease classification should be used when the criteria in 840-10-25-43(a) are met.

However, if the lessor sells the leased asset and the related nonrecourse debt to a third party before adopting Topic 842, we believe the acquiring entity could conclude that leveraged lease classification is appropriate if the criteria in paragraph 840-10-25-43(c) are met. This may be the case because the fair value and carrying amount of the leased asset will be the same for the acquiring entity at the acquisition date, potentially resulting in direct financing lease classification.



## Question 7.8.70

**Nonrecourse debt obtained after lease inception**

**Can a lease meet the leveraged lease classification criteria if the lessor obtains nonrecourse debt subsequent to lease inception?**

**Interpretive response:** No. Paragraphs 840-10-25-1 and 840-10-25-43 require lease classification to be determined at lease inception. As a result, if at the inception date the lessor has not obtained nonrecourse financing from a long-term creditor (thereby not meeting the criterion in paragraph 840-10-25-43(c)(3)), the lease is not a leveraged lease.

Paragraph 840-10-35-4 stipulates that if the lessee and lessor agree to change the lease provisions and the change in terms would have resulted in a different lease classification had those terms been in place at lease inception, it is treated as a new lease agreement that is assessed for classification. However, a change in the method of financing by the lessor would not be considered a change in lease provisions, and therefore lease classification is not subject to change.



## Question 7.8.80

**Substantial leverage in a leveraged lease**

**What represents 'substantial leverage' when evaluating the leveraged lease classification criterion in paragraph 840-10-25-43(c)(3)?**

**Background:** Paragraph 840-10-25-43(c)(3) requires that a lessor obtain nonrecourse financing from a long-term creditor that provides the lessor substantial leverage in the transaction to meet leveraged lease classification. However, no guidance is given in Topic 840 about what constitutes substantial leverage.

**Interpretive response:** We believe a lessor has substantial leverage in the transaction if the nonrecourse debt represents at least 50 percent of the cost of the leased asset. Topic 840 does not preclude leveraged lease classification if the lessor uses recourse financing in addition to nonrecourse financing if the nonrecourse financing is sufficient to provide the lessor substantial leverage in the transaction – i.e. at least 50 percent of the cost of the leased asset.



## Question 7.8.90

**Requirement for the investment to decline during the early years and rise during the later years**

**How much does the lessor's net investment in the lease need to decline, and for how long does it need to decline, to meet the criterion in paragraph 840-10-25-43(c)(4) for leveraged lease classification?**

**Background:** To qualify for leveraged lease classification, the lessor's net investment in the lease must decrease during the early years of the lease once the investment has been completed and then rise during the later years before completion of the lease. However, no guidance is given on what level of decrease needs to occur in the early part of the lease, or how long that decrease needs to occur, to meet the criterion in paragraph 840-10-25-43(c)(4).

**Interpretive response:** We believe the decline, and in turn the subsequent increase, in the lessor's net investment must be more than insignificant relative to the initial net investment. Additionally, we believe the decline in the net investment and the subsequent increase should each last at least one quarter. However, we do not believe it is necessary for the net investment to become negative for a lease to qualify for leveraged lease classification.



## Question 7.8.100

**Lessor receives no tax benefits****Is leveraged lease accounting appropriate when a lessor receives no tax benefits associated with ownership of the leased asset?**

**Background:** Typically, a lease meets the criterion for leverage lease classification under paragraph 840-10-25-43(c)(4) because recognition of tax benefits early in the lease term causes the net investment in the lease to decline before increasing later in the lease term. However, there could be situations where a lessor receives no tax benefits associated with ownership of the leased asset, such as when the lessor operates in a jurisdiction that is not subject to income taxes. A lease could still have the characteristic that the lessor's net investment declines during the early years before increasing in the later years without the effect of tax benefits associated with ownership of the asset, depending on how rent and debt payments are structured.

**Interpretive response:** Yes, if all of the leveraged lease classification criteria in paragraph 840-10-25-43(c) are met. The criteria for leveraged lease classification in Topic 840 do not require a lessor to recognize any tax benefit associated with owning the leased asset.



## Question 7.8.110

**Lessor is a partnership or a variable interest entity****When the lessor is a partnership, can a noncontrolling partner look through the partnership structure to view itself as an equity participant in an underlying lease in determining if leveraged lease classification is appropriate for equity method accounting?**

**Background:** When a lessor is structured as a partnership, the tax benefits associated with the lease are not recognized by the partnership because it is not a taxable entity. The tax benefits are passed through to the partners and reflected in their financial statements. As a result, at the partnership level, leveraged lease classification will often not be appropriate because the lack of income tax benefits causes the criterion in paragraph 840-10-25-43(c)(4) to not be met. However, the lack of income tax benefits on the part of the lessor may not always cause leveraged lease classification to not be met (see Question 7.8.100).

**Interpretive response:** No. We do not believe a noncontrolling partner should look through the partnership in assessing leveraged lease classification. The noncontrolling partner should not reassess lease classification determinations that were made at the partnership level when applying the equity method of accounting.

Similar issues arise when the lessor partnership is a variable interest entity (VIE) and the partner with the majority voting interest is not the primary beneficiary of the VIE based on the requirements of Subtopic 810-10 (consolidation); see chapter 4 of KPMG Handbook, [Consolidation](#). As a result, the partner with the majority voting interest is precluded from consolidating the partnership, which may result in leveraged lease accounting not being appropriate if the criteria in paragraph 840-10-25-43(c) are not met at the partnership level.

### 7.8.3 Recognition and measurement

7.8.70 The lessor in a leveraged lease recognizes and measures its initial investment net of the nonrecourse debt. That net investment, recognized on the lessor's balance sheet, comprises:

- rentals receivable, net of that portion of the rental applicable to principal and interest on the nonrecourse debt;
- a receivable for the amount of the investment tax credit to be realized on the transaction;
- the estimated residual value of the leased asset; and
- unearned and deferred income comprising (1) the estimated pretax lease income (or loss), after deducting initial direct costs, remaining to be allocated to income over the lease term, and (2) the investment tax credit remaining to be allocated to income over the lease term. [842-50-30-1]

7.8.80 The estimated residual value of the leased asset 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.

7.8.90 While deferred taxes are included in the net investment in the leveraged lease for purposes of calculating the lessor's income, they are presented on the lessor's balance sheet with other deferred tax balances accounted for in accordance with Topic 740 (income taxes) and are not netted against the net investment in the leveraged lease. Deferred taxes on leveraged leases are accounted for in accordance with guidance in Topic 842 and are specifically excluded from the accounting for income taxes in Topic 740. [842-50-45-1]

7.8.100 If at inception of a leveraged lease the projected net cash receipts over the term of the lease are less than the initial investment in the leveraged lease, the lessor recognizes a loss at lease inception for that difference.

### 7.8.4 Subsequent measurement

7.8.110 The investment in the leveraged lease net of the related deferred taxes represents the lessor's net investment in the leveraged lease and is used to determine periodic income from the lease. The determination of the net investment in the leveraged lease and the amount of income recognized are

interrelated. The income on the leveraged lease is determined using a rate that, when applied to the net investment in the years when the net investment is positive, will distribute the net income to those years. The result is the recognition of lease income at a level rate of return on the net investment in those periods where the net investment is positive as of the beginning of the period. [842-50-35-2]

7.8.120 Generally, the net investment in a leveraged lease will be positive in its early years based on the initial investment in the leased property, become negative in the middle years due to tax deductions from accelerated tax depreciation and interest payments on the nonrecourse debt, return to positive in the later years due to reversal of accelerated depreciation and reduced interest payments, and end at zero when the property is sold and the residual value is realized.

7.8.130 The income or loss that is recognized by a lessor on a leveraged lease is segregated into: [842-50-35-3]

- pretax lease income;
- tax effect of pretax lease income; and
- investment tax credit.

7.8.140 The amount of each element recognized during each accounting period is based on the ratio of the after-tax net income for the period to the total after tax net income from the lease times the total of those three elements (total pretax lease income, total tax effect of pretax lease income and total investment tax credit). If at any time during the lease term the determination of lease income would result in allocation of a loss to future periods, that loss is recognized immediately. [842-50-35-3 – 35-4]



### Question 7.8.120

#### Differences in timing between when an investment tax credit is earned and realized

**When a lessor recognizes the tax benefits of an investment tax credit in one period but does not receive the cash benefit until a subsequent period, how should the lessor treat the assumed cash flows associated with the investment tax credit for purposes of determining income recognition for the leveraged lease?**

**Interpretive response:** Income recognition for a leveraged lease is structured based on the timing of expected cash flows. This suggests that the lessor should use the period when the investment tax credits are realized when determining the timing of expected cash flows. However, some lessors have included investment tax credits in expected cash flows in the period they are earned. We believe either approach is acceptable.



## Question 7.8.130

**Impact of intra-entity allocation of leveraged lease tax benefits**

**How should a lessor determine the after-tax cash flows associated with a leveraged lease when it is a member of a consolidated group and the tax benefits paid to it by the parent are different from the overall tax benefits applicable to the consolidated entity?**

**Background:** A lessor that is a member of a consolidated group might receive tax benefits from the parent that differ from the overall tax benefits applicable to the consolidated entity if, for example, the lessor is paid only those tax benefits by the parent that would be realizable by the subsidiary on a stand-alone basis.

**Interpretive response:** Current and deferred tax expense for a group that files a consolidated tax return should be allocated among the members of the group for their stand-alone financial statements using a method that is systematic, rational and consistent with the broad principles established by Topic 740.

Although Topic 740 does not prescribe a single allocation method, in practice, intercorporate tax allocations are generally calculated using the separate return method or the pro rata method (see chapter 10 of KPMG Handbook, [Accounting for income taxes](#)).

In the lessor's stand-alone financial statements, the leveraged lease after-tax cash flows should be consistent with the allocation method used by the consolidated entity, whether under the separate return or pro rata method. However, in the consolidated financial statements the leveraged lease after-tax cash flows should be based on the entity's consolidated tax position.



## Question 7.8.140

**Contingent rent**

**How should a lessor account for contingent rent in a leveraged lease?**

**Interpretive response:** We believe contingent rent in a leveraged lease should be accounted for consistently with contingent rent in other lease arrangements and accrued as it is earned. Additionally, the contingent rent should be recorded when earned separately from the leveraged lease account balances and does not affect the net investment in the lease. This means that contingent rentals are not assumptions that need to be established by the lessor as part of projecting leveraged lease cash flows.

However, we believe there could be situations in which contingent rent in a leveraged lease is considered a leveraged lease assumption. This would be the case if the contingent rent payment is based on changes in the interest rate on

the lessor's nonrecourse debt. In this case, treating the contingent rent resulting from the change in interest rate as an important assumption is consistent with the treatment of the mechanism that triggered the contingent rent – i.e. a component of the leveraged lease.



### Question 7.8.150

#### Classification of the net investment in a leveraged lease on a classified balance sheet

#### How should a lessor classify its net investment in a leveraged lease on a classified balance sheet?

**Background:** As described in paragraph 7.8.70, in a lessor's net investment in a leveraged lease the lease receivable is presented net of the nonrecourse debt. If an entity classified a portion of the net investment in the lease as current on the balance sheet, that current portion could become negative as a result of accretion of unearned income.

**Interpretive response:** We believe a lessor should classify its net investment in a leveraged lease entirely as noncurrent on a classified balance sheet.



### Question 7.8.160

#### Presentation of investment tax credit in the income statement

#### How should a lessor present amortization of its investment tax credits on leveraged leases in the income statement?

**Background:** Some lessors record the amortization as operating income because it is viewed as an important part of the rate of return on financing the lease. Other lessors record the amortization as part of the income tax provision.

**Interpretive response:** We believe it is acceptable to present the amortization of investment tax credits on leveraged leases as either a component of operating income or a component of income tax expense. This is an accounting policy choice that should be consistently applied.

## 7.8.5 Changes in leveraged lease assumptions

7.8.150 Topic 842 requires a lessor to review the estimated residual value of the leased asset and all other important assumptions affecting estimated total net income on at least an annual basis. If, as a result of reviewing those important assumptions, the lessor determines that one of the following conditions exists, the lessor recalculates the rate of return and the allocation of lease income to the positive net investment periods from lease inception: [842-50-35-6 – 35-8]

- the estimate of the residual value is determined to be excessive, and the decline is other than temporary;
- the revision to another important assumption changes the estimated total net income from the lease; or
- the projected timing of the income tax cash flows is revised.

7.8.160 On recalculation of the rate of return and allocation of lease income to the positive investment periods after a change in an important assumption, the lessor adjusts the net investment in the leveraged lease to equal the recalculated balance and a gain or loss is recognized. [842-50-35-8]



#### Question 7.8.170

#### **Impact of changes in leveraged lease assumptions under Topic 842**

#### **Would a change in an important assumption be considered a modification that would cause grandfathering of leveraged lease accounting to be terminated?**

**Interpretive response:** No. Leveraged lease accounting requires lessors to use certain assumptions at inception of the leveraged lease and throughout its term. Those assumptions are monitored and revised, as necessary, during the term of the leveraged lease and updates to the assumptions in accordance with paragraph 7.8.150 would not be considered a contract modification.

However, if the terms of the leveraged lease agreement were changed, that would represent a modification and grandfathering of leveraged lease accounting would be terminated. [842-10-65-1(z)]



#### Question 7.8.180

#### **Change in the interest rate on nonrecourse debt**

#### **How should a lessor account for a change in the interest rate on the nonrecourse debt for a leveraged lease?**

**Interpretive response:** The interest rate on the nonrecourse debt is an important assumption that would be subject to reassessment on at least an annual basis. During the term of the leveraged lease, the lessor may refinance the debt, resulting in a change to the lessor's cash flow assumptions for the leveraged lease. In this scenario, the revised cash flow assumptions are recognized immediately as a catch-up adjustment in the period of the change in accordance with paragraph 7.8.150.

If the refinancing of the nonrecourse debt results in a change in the amount of principal (i.e. the lessor borrows an amount greater than the original loan), the incremental borrowing is not offset in the net investment in the leveraged lease. Instead, it is presented separately in the financial statements and the

cash flows related to the incremental borrowing are not included in the accounting for the leveraged lease.



### Question 7.8.190

#### Refinancing nonrecourse debt with recourse debt

### What is the effect of the lessor refinancing nonrecourse debt with recourse debt after inception of a leveraged lease?

**Interpretive response:** When the lessor refinances the nonrecourse debt with recourse debt, we believe this is similar to a delayed equity contribution. If, at the point in time the lessor refinances the debt, the amount of the nonrecourse debt continues to create 'substantial leverage', leveraged lease classification is retained and the changes in projected cash flows are treated as a change in an important assumption.

However, if the change in financing structure would have resulted in failing to qualify for leveraged lease classification at lease inception, leveraged lease classification should be discontinued and the lease accounted for prospectively as a direct financing lease. The direct financing lease would be accounted for without a cumulative catch-up adjustment that would be necessary had leveraged lease classification been retained.



### Question 7.8.200

#### Change in the projected timing of income tax cash flows

### How should a lessor that has classified a lease as a leveraged lease account for a change in the projected timing of income tax cash flows?

**Interpretive response:** The projected timing of the income tax cash flows is particularly important because of its effect on the periodic income recognized by the lessor. The tax benefits are often recognized by the lessor in the early part of the lease term, resulting in a disproportionately higher amount of income recognized in the earlier periods of the lease. If the projected timing of those income tax cash flows is revised, for example as a result of settlements with taxing authorities due to challenges in the timing of tax deductions, the lessor recalculates the rate of return and the allocation of income to positive investment years consistent with paragraph 7.8.150. In the case of a settlement with taxing authorities, this may include related interest and penalties, which should not be considered a change in the estimated total income from the leveraged lease. [842-50-35-9 – 35-15]

The projected timing of the income tax cash flows could also be affected for other reasons. For example, to the extent that a lessor is unable to use anticipated tax benefits in the period they are earned, the projected timing of

the cash flows may be significantly affected even though total net income may not change if the lessor ultimately expects to be able to fully realize the tax benefits in future periods. In this situation, the lessor should not view the change in projected timing of income tax cash flows as a change in an important assumption because the estimated total net income for the lease is not changed. To the extent the lessor believes it will not ultimately be able to use the tax benefits, it would be viewed as a change in an important assumption, requiring recalculation of the rate of return and the allocation of income to positive investment years.



### Question 7.8.210

#### Impact of change in income tax rate on the accounting for a leveraged lease

#### How should a lessor treat the effect of a change in income tax rate on its accounting for a leveraged lease?

**Interpretive response:** If there is a change in the applicable tax rate, the lessor recognizes the effect of the rate change as a gain or loss in the accounting period during which the legislation affecting the change in income tax rate is enacted.



### Question 7.8.220

#### Payments under a tax indemnification agreement

#### How should a lessor treat payments received from a lessee that are a result of tax indemnification agreements?

**Background:** Lease agreements may include indemnification agreements where the lessor is protected from adverse changes in law. For example, in the event of changes in tax legislation that increase applicable income tax rates, the lease agreement may provide that payment from the lessee will increase to compensate the lessor for its increased tax costs.

**Interpretive response:** A lessor should treat tax indemnification payments that it has received, or expects to receive based on enacted legislation, as a change in an important assumption if the lessor's total estimated net income under the leveraged lease is affected as a result of the indemnification. When the indemnification is structured such that the lessor is compensated by the lessee in the amount of any increase in tax obligations resulting from changes in rates, the lessor's total estimated net income and timing of cash flows may not be affected and no reassessment of the leveraged lease may be necessary.



## Question 7.8.230

**Treatment of a sale of the appreciation in the residual value of the underlying asset****How should a lessor account for a sale to a third-party investor of any appreciation in the residual value of the underlying asset in a leveraged lease?**

**Background:** Under Subtopic 842-50, a lessor does not recognize any upward adjustment to the residual value of the underlying asset. However, during the term of a leveraged lease, the lessor may realize the economic benefits of an increase in the residual value of the underlying asset by selling an interest to a third party in any appreciation in the residual value. [842-50-35-8(c)]

**Interpretive response:** The lessor should include any payment from the third-party investor to purchase the interest in the appreciated value of the underlying asset's residual value as a change in a leveraged lease assumption under paragraph 842-50-35-6 (see paragraph 7.8.150) and recalculate the projected cash flows from the leveraged lease by including the payment received in the current period. Income tax effects of the payment should be included in the revised projected cash flows in the period in which the tax will be assessed. The lessor should record a gain or loss in the period in which the change in assumption was made (see paragraph 7.8.160).

No change should be made to the expected residual value of the underlying asset established at inception of the lease if there is no indication that the value has declined.



## Question 7.8.240

**Leveraged lease classification when investment tax credits are accounted for differently****When investment tax credits are accounted for other than as prescribed in paragraphs 842-50-30-1 and 35-4, how should a lessor account for the leveraged lease?**

**Background:** An investment tax credit may be accounted for other than as prescribed in Topic 842, as approved by Congress in the Revenue Act of 1971.

**Interpretive response:** A lease meeting the definition in paragraph 840-10-25-43(c) should be accounted for by the lessor using the method described in Subtopic 842-50. An exception arises if the investment tax credit is accounted for other than as stated in paragraphs 842-50-30-1 and 35-4, in which case the lease should be classified in accordance with the requirements of paragraphs 842-10-25-2 through 25-3A (i.e. not as a leveraged lease).



## Question 7.8.250

**Acquisition of a grandfathered leveraged lease****Is a leveraged lease acquired on or after the effective date of Topic 842 still accounted for as a leveraged lease?**

**Interpretive response:** The acquisition of a grandfathered leveraged lease on or after the effective date of Topic 842 does not change that lease's classification as a leveraged lease (i.e. the lease remains subject to the leveraged lease guidance in Subtopic 842-50) unless it is modified as part of the acquisition. A grandfathered leveraged lease loses its grandfathered status only if it is modified on or after the effective date, including modifications that occur in an asset acquisition or business combination. [842-10-65-1(z)]



## Observation

**Decision to grandfather leveraged leases**

7.8.170 The Board's decision to eliminate leveraged lease accounting was intended to reduce complexity in the lessor accounting requirements and to converge with IFRS Accounting Standards, which have no specialized accounting for leveraged leases.

7.8.180 However, the Board decided to grandfather leveraged leases that commence before the effective date of Topic 842, on the basis that the costs for lessors to unwind their accounting would exceed the benefits to financial statement users of doing so. This decision requires lessors with leveraged leases to retain their existing systems and controls for those transactions until the leases are terminated, which may be several decades. [ASU 2016-02.BC397]

7.8.190 Therefore, lessor accounting for similar leases may differ solely depending on whether the lease commences shortly before or shortly after the effective date of Topic 842. As a result, the decision to grandfather existing leveraged leases may make it difficult for financial statement users to compare the financial statements of those lessors to those of other lessors prepared under US GAAP and IFRS Accounting Standards.

# 8. Subleases

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**New item added in this edition: \*\***

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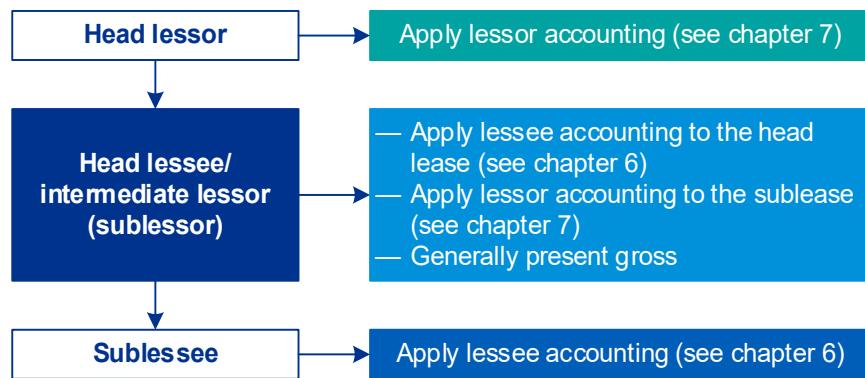
**Example**

- 8.2.10 Classification and accounting for a sublease transaction by a sublessor

**Comparison to legacy US GAAP**

## How the standard works

The following flowchart summarizes the accounting for each party to a lease and sublease transaction.



We expect that most subleases under Topic 842 will be classified as operating leases by sublessors.

Section 6.5.2 includes important considerations for when a lessee subleases a portion of an underlying asset (e.g. one floor of an entire leased building).

## 8.1 General requirements

### 8.1.1 Sublease classification



#### Excerpt from ASC 842-10

##### 25 Recognition

###### General

**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**.

8.1.10 The sublessor and sublessee classify a sublease by reference to the underlying asset subject to the lease, rather than by reference to the ROU asset. This means that, in determining the classification of the sublease, the sublessor and the sublessee consider: [842-20-25-6]

- the term of the sublease as compared to the remaining economic life of the underlying asset – rather than, for example, the remaining term of the head lease; and
- the present value of the sum of the sublease payments and any residual value guarantee provided by the sublessee as compared to the fair value of the underlying asset – rather than the fair value of the head lease ROU asset.



#### Observation

##### Sublease classification

8.1.20 A sublessor classifies a sublease by reference to the underlying asset, not the ROU asset arising from the head lease. The Board determined that applying the lease classification guidance by reference to the underlying asset would be more operational for sublessors because, for example, it may be difficult to determine the fair value of the ROU asset in the head lease. [IASU 2016-02.BC116]

8.1.30 The Board also reasoned that classifying a sublease by reference to the underlying asset would result in more consistent lease classification outcomes for similar leases. For example, if sublease classification were determined on the basis of the remaining economic life of the head lease ROU asset, it would be difficult to understand and explain the following when the same underlying asset is being leased, under potentially similar terms, and with similar periods of use: why the head lessor (or any other lessor) would classify the head lease as an operating lease, while the sublessor might classify the sublease as a sales-type or direct financing lease. [IASU 2016-02.BC116]

8.1.40 The sublease classification requirements in Topic 842 will generally result in operating lease classification for most subleases.

## 8.1.2 Sublessor



### Excerpt from ASC 842-30

#### 35 Subsequent Measurement

##### General

> Subleases

**35-7** If the original **lessee** enters into a **sublease** or the original **lease** agreement is sold or transferred by the original lessee to a third party, the original **lessor** shall continue to account for the lease as it did before.

#### 40 Derecognition

##### General

> Sales-Type and Direct Financing Leases

• > Subleases

**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.



#### Question 8.1.10

#### Accounting for the head lease when a sublease exists

#### Does entering into a sublease with a term longer than the remaining head lease term trigger a remeasurement of the head lease?

**Interpretive response:** Yes. Two parties may enter into a sublease where the non-cancellable period of the sublease, or the sublease term (i.e. including one or more optional periods), exceeds the lease term for the head lease. The act of entering into the sublease is a significant event within the control of the sublessor that directly affects the assessment of the lease term. Therefore, the sublessor needs to update the head lease term to be at least equal to the sublease term, which will then trigger a remeasurement of the head lease. See section 6.6.1 for additional examples of events that trigger a reassessment of the lease term. [842-10-55-28]



### Question 8.1.20

#### **Impact of sublease renewal options on head lease term**

**Does the head lease term include all renewal options that the head lessee (sublessor) can be required to exercise under the terms of a sublease?**

**Interpretive response:** Not necessarily. Based on discussions with the FASB staff, the substance of which were discussed and affirmed by the Board at a November 2016 Board meeting, we believe entering into a sublease that includes renewal options that *could* compel the sublessor to exercise one or more renewal options it has in the head lease does not automatically trigger a change to the head lease term.

Entering into the sublease is a significant event within the control of the head lessee such that the head lessee needs to reassess the lease term at that time. However, unless the sublessee is reasonably certain (see section 5.2) to exercise its renewal option (which would compel the head lessee to do likewise – see Question 8.1.10), the sublessee's renewal option will not, in isolation, trigger a change to the head lease term (and therefore a remeasurement of the head lease liability). [842-10-35-1, 55-28]



### Question 8.1.30

#### **Impact of sublease purchase options on assessment of head lease**

**Does a sublessee option to purchase the underlying asset trigger a remeasurement of the head lease by the head lessee?**

**Background:** A head lessee may convey its option to purchase the underlying asset to a sublessee as part of a sublease.

**Interpretive response:** It depends. Entering into the sublease is a triggering event that requires the head lessee to reassess its option to purchase the underlying asset (as well as the head lease term) – see section 6.6.1. The head lessee will remeasure the lease if it *or* the sublessee is reasonably certain to exercise the purchase option.

If neither the head lessee, nor the sublessee, is reasonably certain to exercise the purchase option, the head lessee will not remeasure the lease (assuming no other changes – e.g. to the lease term or to the amount probable of being owed under a residual value guarantee – trigger a remeasurement).



### Question 8.1.40 **Sublessor reassessments**

#### **Do sublessors ever reassess their accounting for a sublease absent a modification?**

**Interpretive response:** No. Topic 842 requires sublessors to apply the lessor accounting guidance to the sublease. Therefore, sublessors do not reassess their accounting for the sublease – e.g. reassess the sublease term or sublessee purchase options – after the commencement date unless the sublease is modified (and that modification is not accounted for as a separate contract – see section 7.6).

Because the sublessor is also a lessee (i.e. in the head lease), the differences between the lessee and the lessor reassessment requirements may result in circumstances in which the sublessor will reassess its accounting for the head lease, but make no changes to its accounting for the sublease.



### Question 8.1.50 **Impact of sublessee actions on sublessor accounting for the head lease**

#### **Do sublessee actions trigger reassessments of the head lease by the sublessor?**

**Interpretive response:** In general, no. We believe that sublessors are not required to monitor for any changes to the *sublessee's* facts or circumstances in accounting for the head lease. Rather, consistent with any other lease for which the sublessor is a lessee (i.e. those leases not subject to a sublease), the sublessor only reassesses its accounting for the head lease upon the occurrence of a significant event or change in circumstances within its control. For example, while the sublessor may be aware of the sublessee constructing significant leasehold improvements or making significant customizations to the underlying asset, assuming such actions are not within the sublessor's control (i.e. the sublessor is not requiring those improvements or modifications), they would not trigger a reassessment.

However, if a sublessor has provided a residual value guarantee to the head lessor, the sublessor will need to monitor whether there are changes in the amount probable of being owed to the head lessor under the residual value guarantee.

## **8.1.3 Sublessee**

8.1.50 A sublessee classifies and accounts for the sublease as it would any other lease (see chapter 6). From the sublessee's perspective, the fact that the lease is a sublease has no effect on its accounting for the lease. Practically, this

is because a sublessee may not know the terms and conditions of the head lease, and on some occasions may not even know that the lease is a sublease, making it difficult to apply the lease classification guidance by reference to the head lease ROU asset.

## 8.2 Accounting by the sublessor



### Excerpt from ASC 842-20

#### **35 Subsequent Measurement**

##### **General**

> Subleases

**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.

## 40 Derecognition

### General

> Subleases

**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.

8.2.10 The head lease and the sublease will generally be accounted for separately – i.e. as two separate units of account. This is because, even if the contracts are entered into at or near the same date, the sublessee is generally a third party unrelated to the head lessor. Two or more contracts are potentially combined under Topic 842 only if they are entered into at or near the same time and with the same counterparty (or a related party of the counterparty) – see section 4.6. [842-10-25-19, ASU 2016-02.BC115]

8.2.20 In accounting for the sublease, the sublessor follows these steps.

<b>Step 1</b>	<b>Determine the discount rate for the sublease</b>
<b>Step 2</b>	<b>Determine the classification of the sublease</b>
<b>Step 3</b>	<b>Account for the sublease</b>

### 8.2.1 Step 1: Determine the discount rate for the sublease

8.2.30 The sublessor in a sublease transaction uses the rate implicit in the sublease to determine classification of the sublease, and to measure the net investment in the sublease if it is classified as a sales-type or direct financing lease. The rate implicit in the sublease is the rate that balances the following equation. [842-20-35-15]



Notes:

1. The residual value and the fair value of the head lease ROU asset are estimated as of the sublease commencement date.

2. These are initial direct costs that relate to the sublease. They do not include the sublessor's initial direct costs of the head lease.

8.2.40 However, if the rate implicit in the lease cannot be readily determined, a sublessor may use the discount rate established for the head lease; for example, the sublessor's incremental borrowing rate at the commencement date of the head lease. [842-20-35-15]



### Question 8.2.10

#### Use of the rate implicit in the sublease

### When should sublessors and sublessees use the rate implicit in the sublease as the discount rate for the sublease?

**Background:** Topic 842 does not provide explicit guidance for determining the rate implicit in a sublease; however, we believe that the definition of rate implicit in the lease and the specific guidance in Topic 842 means that the rate would be calculated as outlined in paragraph 8.2.30.

**Interpretive response:** Sublessors and sublessees will use the rate implicit in the sublease as the discount rate when that rate is 'readily determinable'.

#### Sublessor

We believe that the rate implicit in a sublease will often not be 'readily determinable' for the sublessor because determining the fair value of an ROU asset may be highly subjective in many cases. Therefore, in classifying and accounting for the sublease, a sublessor will likely use the discount rate for the head lease.

#### Sublessee

Topic 842 is not explicit as to whether the Board intended for the sublessee to use the sublessor's implicit rate in determining the discount rate for the lease if that rate is readily determinable. However, we expect that the rate implicit in the sublease will almost never be readily determinable for a sublessee. This is because the sublessee would need to have insight into all of the following to determine that rate:

- the fair value of the sublessor's ROU asset, which will likely be impossible to determine in most cases because the sublessee will likely not know the terms and conditions of the head lease;
- the sublessor's estimated residual value of the head lease ROU asset, which it will likely not have; and
- the sublessor's initial direct costs resulting from the sublease, which the sublessee will likely not know unless the sublessor provides that information to the sublessee.

Consequently, we believe that a sublessee will, in virtually all if not all cases, use its incremental borrowing rate as the discount rate for the sublease.

## 8.2.2 Step 2: Determine the classification of the sublease

8.2.50 The classification of the sublease as a sales-type, direct financing or operating lease is determined in the same manner as any other lease (see chapter 7). [842-10-25-2 – 25-3A]

## 8.2.3 Step 3: Account for the sublease

8.2.60 The sublease is accounted for as a sales-type, direct financing or operating lease in the same manner as any other sales-type, direct financing or operating lease (see chapter 7).

8.2.70 The accounting for the head lease depends on whether the sublessor is relieved of its primary obligation under that lease. Paragraph 8.2.80 describes the accounting by a sublessor that is not relieved of primary obligation for the head lease; paragraphs 8.2.100 – 8.2.120 address the accounting by the sublessor when it is relieved of that obligation.



Question 8.2.15\*\*

### Sublessor measurement of a sales-type or direct financing sublease

**Does a sublessor measure its net investment in a sales-type or direct financing sublease by reference to the underlying asset or the ROU asset arising from the head lease?**

**Interpretive response:** A sublessor *classifies* a sublease by reference to the underlying asset instead of the head lease ROU asset (see paragraph 8.1.10). However, this concept does not extend to the sublessor's *measurement* of a sublease, which affects the measurement of the sublessor's net investment in the sublease as follows:

- The lease receivable only includes any residual value guarantee of the sublessor's head lease ROU asset. To the extent a sublessee guarantees all or a portion of the residual value of the underlying asset also guaranteed by the sublessor to the head lessor, that guarantee generally is a form of noncash consideration in the contract that is measured at its fair value (see paragraph 5.4.30). If the guarantee is provided at or before lease commencement, it reflects a lease prepayment and therefore would not be included in the measurement of the lease receivable.
- The unguaranteed residual asset equals the unguaranteed portion of the estimated fair value of the head lease *ROU asset* at the end of the sublease term.

Further, as is illustrated in section 8.2.1, it is the ROU asset, not the underlying asset, that affects the rate implicit in the sublease.



## Question 8.2.20

**Sublessor relieved of its primary obligation****How should a sublessor determine whether it has been relieved of its 'primary obligation' under the head lease when it enters into a sublease?**

**Interpretive response:** Determining who is primarily obligated under a lease and when that obligation terminates is a legal matter that depends on the terms of the head lease and, if the lessor under the head lease is a party to the sublease agreement, the sublease. Consultation with qualified legal counsel may be necessary to determine whether a lessee is relieved of its primary obligation under the head lease as a result of entering into a sublease.

The sublessor may consider whether the following scenarios apply in determining whether it has been relieved of its primary obligation.

- If the lessor under the head lease is not a party to the sublease and the provisions of the head lease do not provide for any change in the head lessor's rights and the head lessee's obligations in the event that the property is subleased, the sublease generally should not be accounted for as a termination of the head lease agreement.
- If the head lessor has equal recourse to the head lessee and the sublessee, the sublease generally should not be accounted for as a termination of the head lease.
- If the head lessor continues to have recourse to the head lessee, the terms of the head lease or the sublease (if the head lessor is a party to the sublease agreement) generally would need to provide that the lessor must enforce its rights under the head lease against the sublessee before seeking performance for a shortfall from the head lessee to be able to conclude that the sublease should be accounted for as a termination of the original lease agreement. In effect, the terms of the head lease or the sublease, as applicable, would need to provide for the head lessee to function as a guarantor only.

We believe that a sublessor may be relieved of its primary obligation under the original head lease when:

- a new lessee is substituted under the original head lease agreement and becomes the primary obligor (the original lessee may or may not be *secondarily liable*); or
- a new lessee is substituted through an altogether new lease agreement – with the original head lease agreement being cancelled.

***Sublessor not relieved of its primary obligation under the head lease***

8.2.80 If the sublessor is not relieved of its primary obligation under the head lease, the sublessor accounts for the head lease and the sublease in one of the following ways depending on the classification of the sublease. [842-20-35-14]

**— Sublease is an operating lease. The sublessor:**

- continues to account for the head lease as it did before sublease commencement (see chapter 6);
- continues to assess the head lease ROU asset for impairment (see section 6.5). However, if the lease cost of the head lease for the term of the sublease exceeds the sublease income anticipated for that same period, this is an indicator that the carrying amount of the head lease ROU asset may not be recoverable; and
- recognizes sublease income over the lease term (see section 7.4).

**— Sublease is a sales-type or a direct financing lease, and the head lease is a finance lease. The sublessor:**

- derecognizes the head lease ROU asset using the guidance in Subtopic 842-30 on the derecognition of underlying assets by lessors in sales-type and direct financing leases (see section 7.3.1);
- continues to account for the head lease liability as it did before the commencement of the sublease (see section 6.4);
- recognizes the net investment in the sublease (see section 7.3.1); and
- assesses its net investment in the sublease for impairment using the financial instruments impairment guidance (see section 7.3.2).

**— Sublease is a sales-type or a direct financing lease, and the head lease is an operating lease. The sublessor:**

- derecognizes the head lease ROU asset using the guidance in Subtopic 842-30 on the derecognition of underlying assets by lessors in sales-type and direct financing leases (see section 7.3.1);
- each period following sublease commencement, increases the head lease liability to reflect interest on the lease liability using the effective interest method, and reduces the head lease liability to reflect lease payments made during the period (i.e. accounts for the head lease liability under the finance lease provisions of the lessee accounting guidance – see section 6.4);
- recognizes the net investment in the sublease (see section 7.3.1); and
- assesses its net investment in the sublease for impairment using the financial instruments impairment guidance (see section 7.3.2).



### Question 8.2.25

#### **Underlying asset use rights before an assignment occurs**

**How does a lessee account for a lease it has agreed to assign to a third party if the third party takes control over the use of the underlying asset before the assignment occurs?**

**Background:** Consider a scenario in which an entity sells a business unit to a third-party acquirer. The entity has a series of leases that it and the acquirer agree will be assigned to the acquirer. In this scenario, the legal assignment of the lease will relieve the entity of its primary obligation for the lease (see Question 8.2.20).

However, some of those leases are not yet assigned by the acquisition date (e.g. because some of the lessors have yet to agree to the assignments), despite the acquirer having control over the use of the underlying assets from that date.

In this scenario, the question arises about how the entity should account for those leases.

**Interpretive response:** If a lessee has relinquished control over the use of an underlying asset to a third party, but has not yet legally assigned the lease to the third party in a way that it is relieved of its primary obligation under the lease, we believe the lessee has, in effect, granted the third party a sublease.

Paragraph 8.2.80 addresses accounting for a sublease when the lessee has not been relieved of its primary obligation under the head lease.

When the lessee is ultimately relieved of its primary obligation under the head lease (e.g. when the lease gets assigned in the background scenario), it applies paragraphs 8.2.100 – 8.2.120.



### Question 8.2.30

#### **Sublessor recognition of profit (loss) on a sales-type or direct financing sublease**

**When should a sublessor recognize selling profit or loss on a sales-type or direct financing sublease?**

**Interpretive response:** Because a sublessor applies the same guidance a head lessor applies, it will recognize any selling profit or loss on the sublease in the same manner as it would for a sales-type or direct financing head lease.

- Selling profit is recognized at sublease commencement for a sales-type sublease and over the lease term for a direct financing sublease (see section 7.3.1).

- Selling loss is recognized at sublease commencement for any sublease, regardless of whether it is classified as a sales-type or direct financing sublease.



### Question 8.2.35

#### Loss-making sublease entered into before head lease commencement

#### Does a sublessor recognize a loss accrual on entering into a loss-making sublease before the head lease commencement date?

**Background:** Assume a sublessor enters into a ten-year non-cancellable head lease. Before head lease commencement, the sublessor enters into a sublease. The sublease rental payments are less than the head lease payments such that the sublessor will incur a loss on the sublease.

In this scenario, the question arises as to whether the sublessor is required (or permitted) to recognize the sublease loss at sublease inception.

**Interpretive response:** No, we believe the sublessor should not record a sublease loss accrual at sublease inception. Our view is based on the combined effect of the following.

- The FASB has previously stated that sublease losses are outside the scope of Topic 450 (contingencies). Because the scope of Topic 450 was not amended by the new leases guidance, we believe sublease losses remain outside its scope. [FIN 27.10]
- Lessors do not recognize onerous contract provisions for loss-making leases; a loss-making lease affects whether the underlying asset is impaired. And as stated in paragraph 8.2.60, sublessors account for subleases in the same manner as a head lessor would account for the same lease. This means a sublessor should consider whether the head lease ROU asset is impaired in a loss-making sublease. That the head lease ROU asset is not yet recognized means that the sublessor undertakes the impairment analysis at head lease commencement; it does not mean the sublessor should adopt a different accounting model for the lease.
- The FASB has stated that, for lessors, leasing is 'fundamentally, a revenue-generating activity'. Further, vendors in revenue contracts under Topic 606 recognize loss accruals only in specific circumstances (see chapter 13 of KPMG Handbook, [Revenue recognition](#)) that are not analogous to lease contracts generally accounted for as either product sales (sales-type/direct financing leases) or executory service contracts (operating leases). [ASU 2016-02.Summary, BC92]
- It is unclear how such accruals would be accounted for at and after head lease commencement. For example, would an existing sublease loss accrual continue to be separately recognized, or would it be subsumed into the head lease ROU asset? Topic 842 does not mention existing sublease

loss accruals when accounting for a lease at the commencement date; this at least suggests such loss accruals were not contemplated.



## Question 8.2.40 Sublease presentation by sublessors

### How should a sublessor present its net investment in a sales-type or direct financing sublease?

**Interpretive response:** Topic 842 does not provide explicit guidance on the presentation of the net investment in a sales-type or direct financing sublease for sublessors. Topic 842 simply says that sublessors apply the lessor accounting requirements in Subtopic 842-30. This indicates that sublessors are required to present their net investment in subleases separately from other assets on the balance sheet. But it is not clear whether an entity's net investment in sales-type and direct financing subleases should be presented separately from its net investment in sales-type and direct financing leases for which it is the head lessor.

Determining the appropriate presentation – i.e. presenting the entity's net investment in sales-type and direct financing subleases separately from the entity's net investment in sales-type and direct financing head leases – may depend on the extent of the differences in risks between the two types of net investment. However, we expect these instances to be infrequent, because the number of entities with sales-type or direct financing head leases and sales-type or direct financing subleases may be small and because we believe that relatively few subleases for any entity will be sales-type or direct financing subleases.

8.2.90 The sublessor generally presents the expense on the head lease separately from the income on the sublease (i.e. gross presentation) in its income statement. At a June 2014 meeting, the FASB decided an exception would apply if the sublessor records its sublease income as revenue and acts as an agent with respect to the lease under the principal-agent guidance in Topic 606 (see chapter 9 of KPMG Handbook, [Revenue recognition](#)). However, based on the final definition of a lease (see chapter 3) and the amendments made to the Topic 606 principal-agent guidance subsequent to this Board decision, we generally believe it would not be possible to both have a lease and be an agent to the sublease. Therefore, we expect that application of this exception would be extremely rare, if ever. [\[606-10-55-36 – 55-40\]](#)



## Question 8.2.50

**Gross vs. net presentation of sublease income****Is it acceptable to net sublease income against head lease expense in the income statement?**

**Background:** The guidance in paragraph 8.2.90 reflects a joint decision reached by the FASB and the IASB at their June 2014 meeting and is consistent with each Board's publicly available summary of the decisions reached. However, the FASB did not include explicit guidance to the effect of paragraph 8.2.90 in Topic 842 or discuss it explicitly in the basis for conclusions to ASU 2016-02.

Consequently, some have questioned whether it would be acceptable for a head lessee to present sublease income together with the related head lease expense in the income statement – i.e. on a net basis.

**Note:** If the sublessor is not relieved of its primary obligation under the head lease, it is never appropriate to account for the head lease and the sublease on a net basis on the balance sheet.

**Interpretive response:** There are differing views in practice, and we believe that either of the following approaches is acceptable.

**Approach A: Gross presentation in all cases**

Some believe that gross presentation of head lease expense and sublease income is required in all cases other than as described in paragraph 8.2.90.

Notwithstanding the lack of explicit guidance, the basis for conclusions does state that an entity should account for a head lease and a sublease as two separate contracts unless those contracts meet the contract combinations guidance, which can only occur if the head lessor and the sublessee are related parties (which is generally uncommon). It also states that it is appropriate for a head lease and sublease to be accounted for separately. [\[IASU 2016-02.BC115\]](#)

Proponents of this approach believe the Board has been clear that the head lease and sublease are separate contracts, and therefore they should be accounted for separately in all cases.

**Approach B: Net presentation is acceptable in some cases**

Others believe that net presentation is acceptable, but not required, if:

- subleasing is not a significant business activity for the entity (i.e. it is not part of the entity's ongoing major or central operations); and
- the entity's customary business practice in subleasing is to manage occupancy costs and provide it with flexibility to expand and contract occupancy space to meet changing business needs.

Gross presentation is required otherwise.

Proponents of this approach highlight that net presentation under similar circumstances was acceptable under Topic 840 and the FASB has stated that Topic 842 was not intended to significantly change income statement presentation for lessees. In addition, Topic 842 addresses only the balance

sheet presentation of subleases, and net presentation in the circumstances described appropriately reflects the economics of the lease/sublease transaction.

### ***Sublessor relieved of its primary obligation under the head lease***

8.2.100 If the sublessor is relieved of its primary obligation under the head lease (see Question 8.2.20), the head lease is considered terminated, and the sublessor derecognizes the head lease ROU asset and head lease liability, with the difference recognized as profit or loss. [842-20-40-3]

8.2.110 Any consideration paid or received on termination that was not already included in the lease payments is generally included in the calculation of the profit or loss recognized on lease termination. Such consideration might arise, for example, if the lease term of the head lease did not reflect the lessee exercising a termination option. [842-20-40-3]

8.2.120 If a sublease is a termination of the head lease and the head lessee is secondarily liable, the sublessor (as head lessee) recognizes the guarantee obligation using the guidance in Topic 405 (liabilities). Whether or not explicit consideration was paid for that guarantee, the head lessee becomes a guarantor. The guarantee obligation is initially measured at fair value, and that amount reduces (increases) the profit (loss) recognized on lease termination.  
[842-20-40-3, 405-20-40-2]



### **Example 8.2.10** **Classification and accounting for a sublease transaction by a sublessor**

Sublessor SR leases a non-specialized warehouse for designing paint schemes for cars that it manufactures.

#### **Head lease**

The following facts about the head lease (operating lease) at the commencement date are relevant.

Non-cancellable lease term:	15 years
Renewal options:	15 years (3 options of 5 years each)
Purchase option/transfer of ownership:	None
RVG:	None
Lease payments:	Fixed payments of \$30,000 per year in arrears, with a 3% increase each year after Year 1
Present value of lease payments:	\$349,914
Fair value of warehouse:	\$500,000
Remaining economic life of warehouse:	30 years
SR's incremental borrowing rate:	6% (rate implicit in the lease not available)

SR is not reasonably certain to exercise any of the renewal options at lease commencement.

### **Sublease**

At the end of Year 2 of the lease, SR acquires on-line design software that eliminates its need for the warehouse. SR subleases the warehouse to Sublessee SE for the remainder of the head lease term, but SR is not relieved of its primary obligation to the head lessor under the head lease.

The following additional facts about the sublease at the sublease commencement date are relevant.

Non-cancellable lease term:	13 years
Renewal options:	None
Purchase option/transfer of ownership:	None
RVG:	None
Lease payments:	Fixed payments of \$32,000 <sup>1</sup> per year in arrears, with a 3% increase each year after Year 1
Present value of lease payments:	\$332,257
Fair value of warehouse:	\$505,000
Rate implicit in the sublease:	Not readily determinable <sup>2</sup>
Notes:	<ol style="list-style-type: none"> <li>1. The anticipated sublease income exceeds SR's head lease cost for the period of the sublease because of an increase in market rents during the first two years of the head lease.</li> <li>2. The rate implicit in the sublease is not readily determinable because the fair value of the head lease ROU asset is not readily determinable.</li> </ol>

### **Step 1: Determine the discount rate for the sublease**

Because the rate implicit in the sublease is not readily determinable, SR uses the discount rate it established for the head lease: 6%.

### **Step 2: Determine the classification of the sublease**

SR classifies the sublease as an operating lease, based on the following (see section 7.2):

- there is no transfer of ownership and there is no option for SE to purchase the warehouse;
- the sublease term represents only 46% (i.e. not a major part) of the remaining economic life of the warehouse – i.e. of the underlying asset, not the ROU asset; this is calculated based on a sublease term of 13 years, and a remaining economic life of the warehouse at sublease commencement of 28 years;
- the present value of the sublease payments represents only 66% (i.e. not substantially all) of the fair value of the warehouse at sublease commencement; and
- the warehouse is not highly specialized.

### Step 3: Account for the sublease

In this example, SR is not relieved of its primary obligation to the head lessor. The accounting is therefore as follows.

- Because the sublease is classified as an operating lease, SR does not make any accounting entries for the sublease of the warehouse to SE at the sublease commencement date.
- Because sublease income anticipated during the sublease term exceeds SR's expected lease cost for the head lease over that same period of time, the execution of the sublease is not an indicator that the head lease ROU asset may be impaired.
- Absent additional events (e.g. a change to the head lease term resulting from a reassessment or a modification to the head lease or the sublease), SR will continue to account for the head lease throughout the remainder of the head lease term as if it had not entered into the sublease.
- SR will account for the sublease as it would for any other operating lease for which it is the lessor.

The following calculations illustrate the above solution.

#### From head lease commencement through sublease commencement (at end of Year 2) – balance sheet for head lease

	ROU asset	Lease liability
Balance at head lease commencement	\$349,914	\$349,914
ROU asset amortization/lease liability reduction first two years	(32,946)	(19,450)
<b>Balance immediately after sublease commencement</b>	<b>\$316,968</b>	<b>\$330,464</b>

#### Journal entry at sublease commencement

Because the sublease is classified as an operating lease, SR does not make any accounting entries for the sublease of the warehouse to SE at the sublease commencement date.

#### From sublease commencement to end of sublease term – balance sheet

End of year	ROU asset (head lease)	Lease liability (head lease)
2	\$316,968	\$330,464
3	299,598	318,465
4	281,508	304,791
5	262,597	289,313
6	242,758	271,894
7	221,874	252,387
8	199,819	230,634
9	176,459	206,469
10	151,649	179,714

End of year	ROU asset (head lease)	Lease liability (head lease)
11	125,234	150,180
12	97,048	117,664
13	66,910	81,950
14	34,629	42,810
15	-	-

**From sublease commencement to end of sublease term – income statement (presented gross)**

End of year	Sublease income	Head lease expense	Net income (loss)
2	\$ -	\$ -	\$ -
3	38,443	(37,198)	1,245
4	38,443	(37,198)	1,245
5	38,443	(37,198)	1,245
6	38,443	(37,198)	1,245
7	38,443	(37,198)	1,245
8	38,443	(37,198)	1,245
9	38,443	(37,198)	1,245
10	38,443	(37,198)	1,245
11	38,444	(37,198)	1,246
12	38,444	(37,197)	1,247
13	38,444	(37,197)	1,247
14	38,444	(37,197)	1,247
15	38,444	(37,197)	1,247
<b>Total</b>	<b>\$499,764</b>	<b>\$(-483,570)</b>	<b>\$16,194</b>



### Comparison to legacy US GAAP

#### Classification and accounting for subleases by sublessors

8.2.130 In practice, subleases are very common. Topic 842 does not have a significant effect on a sublessor's accounting for the sublease compared to Topic 840; for example, sublease classification and sublease income recognition is effectively unchanged from Topic 840.

8.2.140 In addition, sublessor head lease accounting is substantially unchanged for finance leases; under both Topic 840 and Topic 842, the sublessor continues to recognize the finance lease asset and liability unless the sublessor is relieved of its primary obligation under the head lease. [840-30-35-12]

8.2.150 However, the sublessor's recognition of an ROU asset and lease liability for a head operating lease is a substantial change to the sublessor's accounting for the head operating lease from Topic 840. [840-30-35-12]

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# 9. Sale-leaseback accounting

## Detailed contents

### Item significantly updated in this edition: #

#### How the standard works

##### 9.1 Determining whether a sale/purchase has occurred

###### Observations

Leaseback does not preclude sale/purchase accounting

No sale-leaseback accounting for a finance/sales-type leaseback

Approach to repurchase options different from Topic 606

###### Questions

- 9.1.10 Asset sold is different from the asset leased back
- 9.1.12 Sale-leaseback guidance applicability – finance lease modified to become an operating lease
- 9.1.15 Sale or assignment of a lessee purchase option
- 9.1.18 Sale of construction-in-progress to be leased back in completed form
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- 9.1.21 Sale-leaseback with seller-lessee leasing portion of the asset back under a finance/sales-type lease
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- 9.1.25 Sale/purchase recognition before commencement of the leaseback
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- 9.1.50 Seller-lessee's right of first offer
- 9.1.60 Limitations of risk related to the underlying asset
- 9.1.70 Conflicting transfer of control indicators
- 9.1.80 Seller-lessee participation in buyer-lessor financing
- 9.1.90 Seller-lessee's ability to share in income or profits
- 9.1.100 Different conclusions by the seller-lessee and buyer-lessor

- 9.1.110 Unit of account for determining whether a sale/purchase has occurred

### **Examples**

- 9.1.05 Seller-lessee accounting for failed sale-leaseback transaction when only a portion of the transferred asset is leased back
- 9.1.10 Determining whether a sale/purchase has occurred

### **Comparison to legacy US GAAP**

## **9.2 Accounting for sale-leaseback transactions**

- 9.2.1 Determining whether the sales price is off-market
- 9.2.2 Adjusting the gain or loss for off-market terms
- 9.2.3 Accounting for the leaseback

### **Observations**

Gain recognition consistent with that for any nonfinancial asset

Accounting for related party transactions based on contractual terms

### **Questions**

- 9.2.05 Presentation of a sale-leaseback in the income statement
- 9.2.10 Which formula to apply

### **Examples**

- 9.2.10 Gain recognized by seller-lessee in a sale-leaseback transaction
- 9.2.20 Accounting for a sale-leaseback transaction with off-market terms
- 9.2.30 Accounting for a rent-free lease in a sale-leaseback transaction

### **Comparison to legacy US GAAP**

## **9.3 Accounting for failed sale-leaseback transactions**

### **Questions**

- 9.3.10 Useful life of the underlying asset in a failed sale-leaseback transaction
- 9.3.20 Negative accretion assessed in the aggregate
- 9.3.25 Adjusting the interest rate on a failed sale-leaseback transaction during the financing period
- 9.3.30 Reassessing lease classification in a failed sale-leaseback
- 9.3.40 Buyer-lessor accounting for initial direct costs incurred in a failed sale-leaseback transaction

## Examples

- 9.3.10 Failed sale-leaseback transaction – repurchase option not reasonably certain to be exercised (seller-lessee accounting)
- 9.3.20 Failed sale-leaseback transaction – repurchase option reasonably certain to be exercised (seller-lessee accounting) #
- 9.3.30 Failed sale-leaseback transaction (buyer-lessor accounting)

## Comparison to legacy US GAAP

### 9.4 Lessee control before lease commencement

- 9.4.1 Lessee involvement in the construction or design of the underlying asset

## Questions

- 9.4.05 Control of an underlying asset pre-lease commencement when multiple parties are involved
- 9.4.10 Lessee call option – exercisable only on occurrence of a contingent event
- 9.4.11 Lessee call option – exercisable only at a future date
- 9.4.12 Lessee call option – expires before the end of the construction period
- 9.4.15 Meaning of 'at any point'
- 9.4.20 Lessor put options
- 9.4.30 Land lease (or sublease) at below-market rent
- 9.4.40 Lessee participation in construction period financing
- 9.4.50 Other considerations that demonstrate lessee control of an asset under construction
- 9.4.60 Lessor accounting when lessee controls the underlying asset under construction
- 9.4.70 Accounting for the transfer of construction-in-progress in a build-to-suit scenario
- 9.4.80 Build-to-suit applicability when an underlying asset is modified
- 9.4.85 Identifying the underlying asset under construction
- 9.4.90 Lease of to-be-constructed property improvements on land sold by the lessee to the lessor

## Examples

- 9.4.10 Determining whether a lessee controls the underlying asset before the commencement date (1)
- 9.4.20 Determining whether a lessee controls the underlying asset before the commencement date (2)

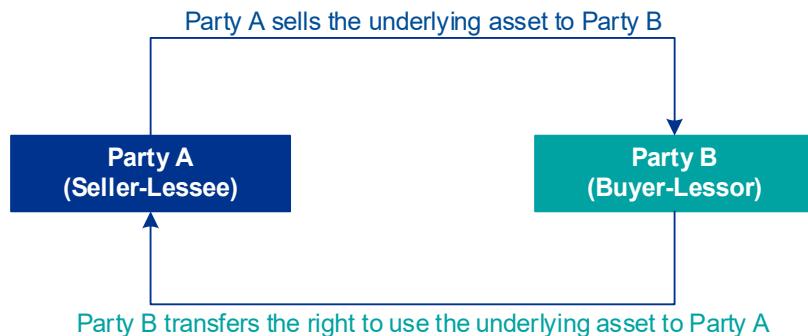
**Comparison to legacy US GAAP****9.5 Transfer of tax benefits****Question**

9.5.10 Sale of tax benefits

**Comparison to legacy US GAAP**

## How the standard works

In a sale-leaseback transaction, one entity (the seller-lessee) transfers an asset to another entity (the buyer-lessor) and then leases that asset back from the buyer-lessor.



Driving the accounting is whether a sale (seller-lessee) and purchase (buyer-lessor) has occurred. This determination is made by each party applying the guidance in Topic 606 to determine whether (1) there is a contract between the parties, and (2) a customer has obtained control of a good.



If a lessee controls the underlying asset before lease commencement, the sale-leaseback transaction guidance applies – i.e. the lessee and the lessor will each have to consider whether or not a sale/purchase occurs and, depending on that conclusion, account for the transaction as a sale and a leaseback (see section 9.2) or a financing transaction (see section 9.3). In the case of a financing, the lessee continues to recognize (and depreciate) the underlying asset until the sale requirements are met. A transaction that does not meet the criteria to be accounted for as a sale/purchase (i.e. that is a 'failed sale/purchase') remains a failed sale/purchase until the requirements to account for it as a sale/purchase are met.

A lessee may control an underlying asset that is being constructed for it to lease at the end of the construction period (commonly referred to as a 'build-to-suit' lease arrangement). In that case, the lessee recognizes the construction-in-process asset and a related financial liability for the lessor's construction costs on its balance sheet. When the construction period ends, the sale-leaseback guidance applies as outlined in the preceding paragraph. If the sale meets the Subtopic 842-40 sale/purchase recognition requirements, the underlying asset and the financial liability for the lessor's construction costs are derecognized. In the case of a failed sale/purchase, the lessee continues to recognize the underlying asset (no longer construction in process, so depreciation

commences) *and* the financial liability for the lessor's construction costs; the lessee accounts for the contractual lease payments as debt service on the financial liability until the sale/purchase recognition requirements are met.



## Excerpt from ASC 842-40

### 05 Overview and Background

#### General

**05-1** 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.

### 15 Scope and Scope Exceptions

#### General

**15-1** This Subtopic follows the same Scope and Scope Exceptions as outlined in the Overall Subtopic; see Section 842-10-15.

**15-2** If an entity (the seller-lessee) transfers an asset to another entity (the buyer-lessor) and leases that asset back from the buyer-lessor, both the seller-lessee and the buyer-lessor shall account for the transfer **contract** and the **lease** in accordance with Sections 842-40-25, 842-40-30, and 842-40-50.

**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.

### 55 Implementation Guidance and Illustrations

#### General

> Implementation Guidance

- > Sale Subject to a Preexisting Lease

**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.

## 9.1 Determining whether a sale/purchase has occurred



### Excerpt from ASC 842-40

#### 25 Recognition

##### General

> 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:

- Paragraphs 606-10-25-1 through 25-8 on the existence of a contract
- Paragraph 606-10-25-30 on when an entity satisfies a performance obligation by transferring control of an asset.

**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**.

**25-3** An option for the seller-lessee to repurchase the asset would preclude accounting for the transfer of the asset as a sale of the asset unless both of the following criteria are met:

- The exercise price of the option is the **fair value** of the asset at the time the option is exercised.
- There are alternative assets, substantially the same as the transferred asset, readily available in the marketplace.

#### 55 Implementation Guidance and Illustrations

##### General

> Implementation Guidance

- > Sale-Leaseback-Sublease Transactions

**55-18** An entity enters into a sale and leaseback of an asset that meets either of the following criteria:

- The asset is subject to an **operating lease**.
- 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.

- > Seller-Lessee Guarantee of the Residual Value

**55-20** The seller-lessee may guarantee to the **lessor** that the residual value will be a stipulated amount at the end of the **lease term**. If the transfer of the asset is a sale in accordance with paragraphs 842-40-25-1 through 25-3, the seller-lessee **residual value guaranteee** should be accounted for in the same manner as any other residual value guarantee provided by a **lessee**.

**55-21** The residual value guarantee does not, on its own, preclude accounting for the transaction as a sale and leaseback, but should be considered in evaluating whether control of the asset has transferred to the buyer-lessor in accordance with paragraph 606-10-25-30. For example, a significant residual value guarantee by the seller-lessee may affect an entity's consideration of the transfer of control indicator in paragraph 606-10-25-30(d).

9.1.10 For a sale (and purchase) to occur in the context of a sale-leaseback transaction, the following conditions must be met: [842-40-25-1, 606-10-25-1 – 25-8, 25-30]

- there is a contract between the parties based on the contract existence criteria in Topic 606; and
- the seller-lessee has transferred control of the underlying asset to the buyer-lessor based on the guidance on satisfying performance obligations in Topic 606.

9.1.20 The transaction can be monetary or nonmonetary. For example, an entity may contribute assets to an unrelated entity in exchange for an equity interest, and concurrently lease back the assets. This arrangement may qualify as a sale-leaseback transaction.



### Question 9.1.10

#### Asset sold is different from the asset leased back

**Is a transaction in which the seller-lessee sells an asset to the buyer-lessor subject to sale-leaseback accounting if the asset leased back is different from the asset sold?**

**Interpretive response:** It depends. If the sale and the lease are included in the same contract or in two or more contracts that must be combined (see section 4.6), we believe the transaction is in the scope of the sale-leaseback guidance if the asset substitution is non-substantive.

For example, we believe the substitution of the leased asset for the one sold is not substantive and the arrangement should be subject to sale-leaseback accounting in the following cases:

- a red Model X car is sold to the buyer-lessor, while a blue Model X car is leased back by the seller-lessee; or
- the cash flows of the two parties are not substantively affected by the lease involving a different asset from the one sold.



### Question 9.1.12

#### **Sale-leaseback guidance applicability – finance lease modified to become an operating lease**

#### **Is modifying a finance lease such that it becomes an operating lease a sale-leaseback transaction?**

**Background:** Under Topic 840, if a change in the provisions of a capital lease gave rise to a new agreement classified as an operating lease, the transaction was accounted for under the sale-leaseback requirements of Subtopic 840-40. [840-40-15-6]

Because of this legacy guidance, the question has arisen as to whether the same conclusion would be reached under Topic 842. In addition to lease modifications, this question has arisen in scenarios structured as a finance lease termination, with a forward starting (e.g. in two years) operating lease of the same underlying asset.

For example, assume a lessee (LE) leased a plot of land from a lessor (LR) for 60 years and appropriately classified the lease as a finance lease. LE intended to construct a facility on the leased land. In Year 2, LE and LR agree instead to have LR finance and construct the facility. LE and LR terminate the existing finance lease agreement and enter into a 20-year lease of the facility, expected to be an operating lease, that will commence upon completion of the facility (expected to take approximately two years). The 20-year lease of the facility includes an implied lease of the underlying land (see paragraphs 4.1.120 – 4.1.130) previously subject to the finance lease.

**Interpretive response:** No. Topic 842 does not include guidance such as that in Topic 840 described in the background. Further, the FASB expressly observed in ASU 2016-02 that finance leases, while similar, are not the same as purchases of assets, and the rights a lessee obtains under a finance lease are different from the rights obtained from asset ownership. [ASU 2016-02.BC57]

There is nothing in Subtopic 842-40 that suggests that sale-leaseback accounting applies, or was intended to apply, to a non-owned asset – i.e. an asset the entity cannot sell or transfer control of (i.e. the ability to direct the use of and obtain substantially all the remaining benefits from) to another entity because it does not own (i.e. control) it.

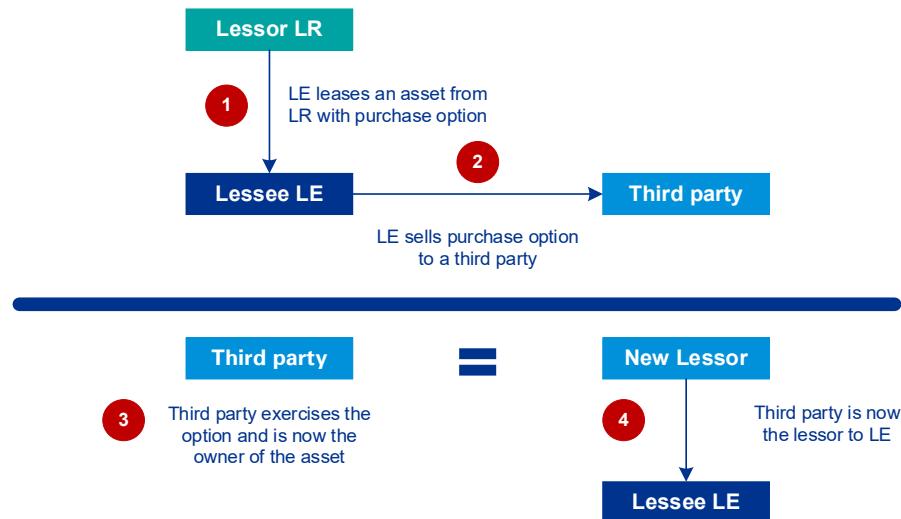


### Question 9.1.15

#### Sale or assignment of a lessee purchase option

**Is a transaction in which a lessee sells or assigns its purchase option to a third party subject to sale-leaseback accounting if the lessee leases the asset from the third party after it exercises the option?**

**Background:** A lessee may sell or assign its option to purchase the underlying asset to a third party (e.g. a financing entity) that is obligated, as a condition of acquiring the option, to exercise the option and lease the asset back to the lessee. The following diagram illustrates this transaction.



**Interpretive response:** In general, we believe accounting for a transaction of this nature is fundamentally the same as the lessee exercising the purchase option itself and then entering into an explicit sale-leaseback transaction with the third party.

However, because the lessee must control the underlying asset before the sale to the third party (new lessor) for the transaction to be in the scope of Subtopic 842-40, the specific facts and circumstances may affect whether the transaction is a sale-leaseback.

We believe this type of transaction is in the scope of Subtopic 842-40 if the purchase option meets all of the following conditions:

- it is substantive – e.g. it is not at a strike price or subject to other terms that no rational economic participant would pay or accept;
- its exercisability is not contingent on the occurrence of a future event or circumstance that is outside the control of the lessee; and

- consistent with paragraph 842-40-25-3 (see paragraph 9.1.50), its strike price is not the exercise-date fair value of the asset unless there are no assets, substantially the same as the asset subject to the purchase option, readily available in the marketplace (see Question 9.1.30).

When these conditions are met, we believe the lessee controls the underlying asset through its purchase option, similar to a lessee controlling an asset under construction that it will lease on completion when it has an option to acquire the asset during the construction period (see paragraph 9.4.70). [842-40-55-5(a)]

If the option is not substantive, or its exercisability is contingent on an event or circumstance outside the lessee's control at the time of the option sale, the lessee does not have the ability to direct the use of, and obtain substantially all the remaining benefits from, the asset before sale of the option.

Similarly, if the strike price of the option is the exercise-date fair value of the asset, and there are assets substantially the same as the asset subject to the option readily available in the marketplace, the owner of the underlying asset (i.e. the original lessor) is not constrained in its ability to direct the use of and obtain substantially all the remaining benefits from the asset. [IASU 2014-09.BC425, ASU 2016-02.BC352(c)]

Given the nuances of the analysis in relation to the facts and circumstances, and the potential for differing interpretations in practice, entities entering into these transactions may want to consult with their accounting advisers before finalizing their accounting treatment.



### Question 9.1.18

#### **Sale of construction-in-progress to be leased back in completed form**

**If a lessee sells construction-in-progress to an unrelated third party that agrees to finish construction and lease the completed asset back to the lessee, is the transaction a sale-leaseback?**

**Background:** An entity (seller) may begin construction of an asset before transferring that asset to an unrelated third party (buyer) that will finance completion of the asset and then lease the completed asset to the seller. The progress toward completion of the construction-in-progress (CIP) at the time of sale may vary.

For example, in the case of a building, it may be that:

- the land has been cleared and/or graded to prepare for construction;
- a physical structure has begun to be erected – e.g. a foundation laid and steel beams erected;
- it is a cold shell – typically a building that lacks heating and cooling, ceilings and interior wall finishings; or
- it is a warm shell – typically a building that includes interior ceilings and walls, as well as lighting, heating/cooling and plumbing.

**Interpretive response:** It depends. Topic 842 does not address this question, and the FASB did not publicly discuss it during the deliberations of Topic 842. Consequently, multiple views have emerged in practice.

Those views range from:

- accounting for the transaction as a sale-leaseback, subject to Subtopic 842-40, once any 'hard costs' have been incurred (e.g. costs to clear and grade the land on which a building will be constructed), no matter how insignificant; to
- accounting for the transaction as a sale-leaseback only if the CIP is 'substantially similar' to the completed asset – i.e. substantially all of the construction is complete.

In between these two ends of the spectrum, others have concluded that sale-leaseback accounting should apply either:

- once a physical structure (e.g. foundation and steel or wood framing for a building) has begun to be erected that will be part of the completed asset; or
- once a substantial portion of the construction is complete, which is typically viewed as far less than the 'substantially all' envisaged in the second view in the preceding paragraph.

In response to this question, the FASB and SEC staffs have expressed the view that there are likely multiple acceptable interpretations about when a transaction of the nature described in the background should be subject to the sale-leaseback guidance in Subtopic 842-40, including all of those outlined in the preceding paragraphs.

Consequently, we believe entities have flexibility, between the two ends of the spectrum described, to establish an accounting policy as to when transactions of this nature are subject to the sale-leaseback guidance in Subtopic 842-40. Entities should apply their policy consistently to similar transactions.

### Determining progress toward completion

During the discussions with the FASB and SEC staffs, progress toward completion of construction at the sale date was principally couched in qualitative terms (e.g. 'substantially similar', 'substantial portion' or 'more than insignificant'), rather than quantitative terms, such as numerical values. Therefore, we do not believe there are bright-line thresholds related to any of the approaches that were discussed.

However, we believe it is generally accepted that if an entity is adopting an approach dependent on progress toward completion of construction at the sale date, the entity would compare either:

- the fair value of the CIP at the sale date to the expected fair value of the completed asset at lease commencement; or
- the costs of construction incurred to the sale date to the expected total construction costs of the completed asset (including those incurred before and after the sale date).

### If the transaction is not a sale-leaseback

Under some of the views being accepted in practice, it is likely that many transactions that would have been subject to the sale-leaseback guidance in Topic 840 will not be accounted for as sale-leasebacks under Topic 842. This is because Topic 840 generally viewed construction to have commenced on an asset if any hard costs had been incurred at the time of sale (no matter how insignificant). [840-40-55-44]

Because of this, the question arises as to the accounting that applies if the transaction is not accounted for as a sale-leaseback under Subtopic 842-40. In those cases, we believe the following considerations are relevant.

- Because the underlying asset that will be leased is under construction, both the lessee (seller) and the lessor (buyer) will need to consider whether the lessee is the accounting owner of the CIP during the remainder of the construction period (see section 9.4). If so, the lessee (seller) should not recognize a sale of the CIP only to immediately re-recognize the CIP on its balance sheet as accounting owner thereof under Topic 842's build-to-suit guidance. Doing so would, in effect, recognize a round-trip sale, which the FASB expressed its desire to avoid under Topic 842 (see paragraph 9.1.100).
- If the lessee is not the accounting owner of the CIP during the remainder of the construction period, the lessee (seller) will apply Topic 606 (if the buyer is a customer) or Subtopic 610-20 (if the buyer is not a customer) to decide whether and when a sale of the CIP occurs. Concurrently, because the symmetrical accounting requirements of Subtopic 842-40 do not apply, the buyer will account for the purchase of the CIP in accordance with other appropriate US GAAP (e.g. Topic 360 or Topic 330).



### Question 9.1.20 Lease-leasebacks

#### Should a lease-leaseback, often referred to as a lease-in, lease-out (LILO), be accounted for as a sale-leaseback transaction?

**Background:** The owner of an asset may lease the asset to a third party and then lease that same asset back from the third party. For example, Entity A may lease an asset to Entity B for 10 years and lease it back from Entity B for three years, concurrently.

**Interpretive response:** If the lease and the leaseback are each part of the same contract, or each part of two or more contracts that are combined (see section 4.6), we do not believe there is a lease and a leaseback for accounting purposes.

Rather, in the Entity A/Entity B example, no lease exists until the three-year leaseback term ends; it is only then that Entity B obtains the right to control the

use of the identified asset. This conclusion is consistent in principle with the Board's conclusion that it is not appropriate to recognize a sale and finance/sales-type leaseback because that would constitute, in effect, a 'round-trip' sale (see paragraph 9.1.100). Similarly, we believe it is not appropriate to conclude that an entity obtains the right to control the use of an identified asset from another entity only for that control to immediately revert back to the other entity.

Accounting for the transaction before the end of the three-year leaseback term depends on the structure of the arrangement. For example, the substance of the transaction may be that of a financing if the lease payments for the 10-year lease (or a significant portion thereof) are prepaid.

9.1.30 Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. [606-10-25-25]

9.1.40 The following are indicators that control of the asset has transferred that should be considered together with an overall evaluation of the control principle. [606-10-25-30]



9.1.50 The existence of the leaseback does not, by itself, preclude an entity from concluding that control of the underlying asset has been transferred to the buyer-lessor. However, the buyer-lessor has not obtained control of the underlying asset if: [842-40-25-2 – 25-3]

- the leaseback results in a lease that would be classified as a finance lease (by the seller-lessee) or as a sales-type lease (by the buyer-lessor); or
- the contract contains a substantive seller-lessee repurchase option with respect to the transferred asset, unless the option:
  - is exercisable only at the fair value of the asset on the exercise date; and
  - there are alternative assets, substantially the same as the transferred asset, readily available in the marketplace.

9.1.60 The term 'readily available' is used in multiple places within Topic 842, and we believe its use is intended to be consistent throughout the Topic. Accordingly, in the context of the seller-lessee repurchase option criterion, we believe the test is whether another asset, substantially the same, is available for purchase separately from the buyer-lessor or from other suppliers.



## Observation

### **Leaseback does not preclude sale/purchase accounting**

9.1.70 The Board's decision that the presence of the leaseback does not, in isolation, prevent the buyer-lessor from obtaining control of the underlying asset appears to potentially conflict with the following in Topic 606:

- defining control of an asset as the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset; and [606-10-25-25]
- the Board's description of the ability to direct the use of an asset as the customer's right to deploy that asset in its activities, to allow another entity to deploy that asset in its activities, or to restrict another entity from deploying that asset. [ASU 2014-09.BC120]

9.1.80 Following that guidance, it appears that the buyer-lessor in a sale-leaseback transaction does not obtain the ability to direct the use of the asset (as defined in Topic 606) until the end of the leaseback term, other than potentially having the ability to sell the asset subject to the lease or enter into a forward-starting lease with another entity that will commence after the leaseback term ends.

9.1.90 Consequently, the Board's decision appears to be based largely on its view that the accounting for a lease should not differ solely because the lessor purchased the underlying asset from the lessee rather than from a third party. The Board observed that a sale-leaseback scenario is not substantively different from many lessor scenarios in which the lessor purchases the underlying asset from a third party only after the terms and conditions of the lease are agreed with the lessee. In those scenarios, similar to a sale-leaseback transaction, the lessor may not take possession of the underlying asset before commencement of the lease (i.e. it may be delivered directly to the lessee) and has no ability to direct its use until after the end of the lease term, other than as described in paragraph 9.1.80. [ASU 2016-02.BC352(a)]



## Observation

### **No sale-leaseback accounting for a finance/sales-type leaseback**

9.1.100 The Board concluded that in a finance (seller-lessee perspective) or sales-type (buyer-lessor perspective) lease, the lessee in effect obtains control of the underlying asset rather than solely a right to control the use of the underlying asset. Therefore, the Board decided that it would be inappropriate to account for a sale and finance/sales-type leaseback transaction as a sale and a leaseback; that would be akin to permitting recognition of a gain by the seller-lessee on a round-trip sale – i.e. the buyer-lessor would obtain control of the asset only to immediately transfer control of the asset back to the seller-lessee. Instead, the Board decided that no sale from the seller-lessee to the buyer-lessor occurs in the first place. [ASU 2016-02.BC352(b)]



### Question 9.1.21

#### Sale-leaseback with seller-lessee leasing portion of the asset back under a finance/sales-type lease

**If a seller-lessee transfers an asset to a buyer-lessor, but leases back a distinct portion of the asset in a lease that would be classified as a finance/sales-type lease, is the transfer of the asset a failed sale?**

**Background:** Certain assets are, or have the ability to be, divided into distinct units. For example, a building may be divided into separable units (e.g. floors, office suites), and a cellular tower includes separable, physically distinct spaces where different parties can attach their telecommunications equipment. In some cases, a larger asset such as a building will be legally subdivided (condominiumized).

The question arises about whether a sale occurs if an asset is transferred, but the seller-lessee leases back a portion of that asset (e.g. one or more floors of the building, space on the cellular tower) under terms that would result in classifying the leaseback as a finance/sales-type lease.

**Interpretive response:** It depends. If the transferred asset has not been legally subdivided, we believe a finance leaseback of a portion of that asset will result in accounting for the transfer of the asset as a failed sale/purchase unless the portion being leased back is only a minor portion of the legally transferred asset.

For example, if a seller-lessee sells a 40-story office building and concurrently enters into a finance leaseback of 18 floors, we believe the transfer of the asset would be accounted for as a failed sale/purchase by the seller-lessee and the buyer-lessor. In contrast, a finance leaseback of two floors, as only a minor portion of the transferred building, would not preclude accounting for the transfer of the building as a sale/purchase.

If the transferred asset has been legally subdivided, we believe each legally subdivided portion of the larger asset should be evaluated separately. If the previous 40-story building had been legally subdivided (condominiumized) into 40 units, the finance leaseback of 18 floors (units) would not preclude accounting for the transfer of the other 22 floors (units) as sales. And, in that case, there is no sale-leaseback transaction for the 22 floors (units), because the seller-lessee is not leasing those floors back from the buyer-lessor after they are sold.



### Question 9.1.22

#### **Accounting for portion of a transferred asset subject to a failed sale/purchase that is not leased back**

**How does an entity account for the portion of a transferred asset that is not leased back to the seller-lessee when the transaction is accounted for as a failed sale/purchase?**

**Background:** Question 9.1.21 includes the example of a transferred 40-story office building that fails sale/purchase accounting because the seller-lessee is leasing back 18 floors of the building under leasebacks that would be classified as finance leases.

Considering that example, the question arises about how the seller-lessee and the buyer-lessor should account for this transaction in which 22 floors of the building are not subject to the contractual leaseback.

**Interpretive response:** From an accounting perspective, in a failed sale transaction, the seller-lessee remains the accounting owner of the transferred asset (i.e. the 40-story building in the background example), just as if it had never entered into the sale-leaseback transaction with the buyer-lessor.

However, in the background scenario, the buyer-lessor controls *the use* of the 22 floors that the seller-lessee is not contractually leasing back – i.e. the buyer-lessor can use those floors or lease them to other entities, despite the seller-lessee's continued accounting ownership of the building.

Therefore, in addition to the other failed sale/purchase accounting impacts (see section 9.3), we believe it is appropriate for both the seller-lessee and the buyer-lessor to account for the lease of those floors from the seller-lessee to the buyer-lessor (i.e. the seller-lessee as accounting lessor, and the buyer-lessor as accounting lessee) just as they would any other lease (see chapters 7 and 6, respectively). This includes evaluating the classification of the implied lease, which could result in sales-type (seller-lessee) or finance (buyer-lessor) lease classification because there is nothing in Topic 842 that would prohibit those classifications in this scenario.

Assuming the buyer-lessor has paid the purchase price for the building upfront, this results in treating a portion of the purchase proceeds as prepaid rent for the deemed lease by the buyer-lessor of the 22 floors. This reduces the financial liability and receivable recognized by the seller-lessee and buyer-lessor for the failed sale/purchase, respectively.

Topic 842 does not prescribe or illustrate how to account for this type of scenario. Therefore, the above may not be the only acceptable approach.



### Example 9.1.05

#### Seller-lessee accounting for failed sale-leaseback transaction when only a portion of the transferred asset is leased back

Seller-Lessee SL enters into a contract (that meets the contract existence criteria in Topic 606) with Buyer-Lessor BL for the sale of a two-story office building. The contractual purchase price of \$1.5 million is paid in full and title to the building transfers to BL immediately. The two floors have not been legally subdivided.

As part of the sale contract, SL and BL agree that BL will lease the second floor of the office building back to SL. The transfer of the building will not qualify as a sale/purchase until the end of the five-year contractual leaseback term on the basis of an option for SL to repurchase the building at the end of the leaseback term.

The following additional facts are relevant.

Building remaining useful life:	15 years
Net carrying amount of building (PP&E) on contractual sale date:	\$1,250,000
Fair value of building on contractual sale date:	\$1,500,000
Annual building depreciation: <sup>1</sup>	\$83,333
Noncancelable leaseback period:	5 years
Leaseback renewal options:	None
Expected residual value of the first floor to SL at end of five-year implied lease term to BL: <sup>2</sup>	\$0
Net carrying amount of each floor on contractual sale date: <sup>1</sup>	\$625,000
Fair value of each floor on contractual sale date: <sup>3</sup>	\$750,000
Contractual leaseback payments: <sup>4</sup>	Fixed payments of \$75,000 / year (in arrears)
Notes:	
1. The carrying amount of the building has been attributed to the two floors of the building on a relative fair value basis (see Note 3), which results in an equal allocation of depreciation to each floor (\$83,333 / 2 = \$41,667).	
2. Because legal title to the entire building has transferred as a part of the contractual sale and BL has paid the full cash consideration (i.e. any associated imputed rental income would be prepaid in nature), there would be no residual value to SL at the end of the lease term.	
3. The fair value of the building has been attributed to the two floors of the building equally on the basis that the floors are substantially equivalent, and that each floor's location relative to the ground (first versus second floor) would not substantively affect its fair value.	
4. The contractual leaseback payments are at market.	

In accounting for this transaction, SL considers that it remains the accounting owner of the entire two-story building throughout its contractual leaseback term of five years, while BL controls the use of the first floor office space during that same time period. Consequently, for accounting purposes (see Question 9.1.22), SL concludes it is leasing (i.e. as lessor) the first floor of the building to BL for this five-year period. SL concludes the lease to BL is a sales-type lease because title to the entire building, including the leased first floor office space, transfers to BL by the end of the lease term (see section 7.2) and the 'Step 0' test (see paragraph 7.2.30) does not apply because none of the payments for this lease are variable.

### Commencement date accounting

All of the lease payments for the sales-type first floor lease are prepaid; BL's contractual \$1.5 million payment to legally acquire the entire building is the only payment BL will make to SL under this contract. Consequently, there is no lease receivable. Additionally, there is no residual value of the first floor to SL because BL owns it; therefore, there is no net investment in this first floor lease.

Accordingly, SL's accounting at the lease commencement date (which is the contractual sale date) is as follows.

	<i>Debit</i>	<i>Credit</i>
Cash <sup>1</sup>	1,500,000	
PP&E <sup>2</sup>		625,000
Selling profit <sup>3</sup>		125,000
Financial liability <sup>4</sup>		750,000

Notes:

1. The total cash received for the legal sale of the building.
2. The carrying amount of the first floor being leased for accounting purposes to BL.
3. The two floors were determined to have an equal fair value. Therefore, SL allocates the \$1.5 million proceeds for the entire building to the two floors equally for purposes of determining the (1) prepaid lease payments for the first floor lease to BL and (2) financial liability resulting from the failed sale of the building.  $\$750,000 - \$625,000 = \$125,000$ .
4. 50% of the \$1.5 million building sale proceeds.

### Subsequent accounting

SL has no additional accounting to undertake for the sales-type first floor lease after lease commencement.

However, it must continue to account for the building and its payments to BL for the contractual leaseback. Based on all the above, SL's accounting throughout the 5-year contractual leaseback term of Floor 2 results in the following.

*Alternative 1: Retain pre-transaction building useful life*

Period	Asset carrying amount	Financial liability balance	Principal portion of paymt	Depn expense	Interest expense	Gain on sale
Commencement	\$ 625,000	\$ 750,000	\$ -	\$ -	\$ -	\$ -
Year 1	583,333 <sup>1</sup>	708,750 <sup>2</sup>	41,250 <sup>3</sup>	41,667 <sup>1</sup>	33,750 <sup>4</sup>	-
Year 2	541,666	665,644	43,106	41,667	31,894	-
Year 3	499,999	620,598	45,046	41,667	29,954	-
Year 4	458,332	573,525	47,073	41,667	27,927	-
Year 5	416,665	524,334	49,191	41,667	25,809	-
Lease end	-	-	-	-	-	107,669 <sup>5</sup>

## Notes:

- Carrying amount at the start of Year 1 (\$625,000) minus annual depreciation of \$41,667 (rounded) for five years. Consistent with one acceptable approach outlined in Question 9.3.10, SL continues to depreciate the building over its pre-existing useful life of 15 years.
- Financial liability balance of \$708,750 = the balance at the beginning of the period minus the principal portion of the Year 1 payment (\$750,000 – \$41,250).
- Principal portion of payment (\$41,250) = the contractual leaseback payment (\$75,000) minus the portion that reflects interest (\$33,750).
- Interest expense is calculated by multiplying the outstanding balance of the financial liability by the interest rate determined in accordance with paragraphs 835-20-25-12 – 25-13 (\$750,000 x 4.5%).
- $524,334 - 416,665 = \$107,669$ .

*Alternative 2: Adjust remaining building useful life to 5 years (salvage value equal to remaining financial liability balance)*

Period	Asset carrying amount	Financial liability balance	Principal portion of paymt	Depn expense	Interest expense	Gain on sale
Commencement	\$ 625,000	\$ 750,000	\$ -	\$ -	\$ -	\$ -
Year 1	604,867 <sup>1</sup>	708,750 <sup>2</sup>	41,250 <sup>3</sup>	20,133 <sup>1</sup>	33,750 <sup>4</sup>	-
Year 2	584,734	665,644	43,106	20,133	31,894	-
Year 3	564,601	620,598	45,046	20,133	29,954	-
Year 4	544,468	573,525	47,073	20,133	27,927	-
Year 5	524,334	524,334	49,191	20,134	25,809	-
Lease end	-	-	-	-	-	- <sup>5</sup>

## Notes:

- Carrying amount at the start of Year 1 (\$625,000) minus annual depreciation of \$20,133. In contrast to Alternative 1, SL depreciates the building assuming a five-year remaining useful life (with a salvage value equal to the financial liability that will be relieved upon sale, consistent with one acceptable approach outlined in Question 9.3.10).
- Financial liability balance of \$708,750 = the balance at the beginning of the period minus the principal portion of the Year 1 payment (\$750,000 – \$41,250).
- Principal portion of payment (\$41,250) = the contractual leaseback payment (\$75,000) minus the portion that reflects interest (\$33,750).

4. Interest expense = prior year financial liability balance (\$750,000) x interest rate determined in accordance with paragraphs 835-20-25-12 – 25-13 (4.5%).
5.  $\$524,334 - \$524,334 = \$0$ .



### Question 9.1.25

#### **Sale/purchase recognition before commencement of the leaseback**

#### **Can a sale/purchase in a sale-leaseback transaction be recognized by the seller-lessee or the buyer-lessor before the commencement date of the leaseback?**

**Background:** While infrequent in conventional sale-leaseback transactions, two entities may enter into a forward-starting leaseback. For example, the seller-lessee transfers the asset to the buyer-lessor on January 1, 20X1 and the leaseback commences July 1, 20X1.

More commonly, this issue may arise in build-to-suit lease arrangements (see section 9.4) when the lessee is deemed the accounting owner of the asset under construction. A call option or another feature of the arrangement that resulted in the lessee's accounting ownership may be 'cured' before the lease commencement date – e.g. a call option the lessee had over the construction-in-process may expire before the end of the construction period.

**Interpretive response:** No. We do not believe a sale (seller-lessee) or purchase (buyer-lessor) can occur before the lease commencement date. This is because lease classification directly affects whether a sale/purchase occurs in a sale-leaseback transaction (see paragraph 9.1.50 and the observation in paragraph 9.1.100), and lease classification is required to be assessed at lease commencement.

Despite the fact that there may be a high level of confidence about how the lease will be classified, an entity cannot be certain of the lease classification until the lease commencement date. This is because multiple estimates that affect lease classification, such as the fair value of the underlying asset, the underlying asset's remaining economic life, and the discount rate for the lease, could all be affected by intervening events before the lease commencement date.



### Question 9.1.30

#### Seller-lessee repurchase option involving real estate

**Does a seller-lessee repurchase option in a sale-leaseback transaction involving real estate *always* result in a failed sale/purchase?**

**Interpretive response:** Yes. The Board has stated that, in its view, no two real estate assets are 'substantially the same.' This includes, for example, two adjacent store fronts in the same shopping center or two adjoining townhouses or condominiums. Therefore, a repurchase option (at any strike price) for a real estate asset will never meet the criterion for there to be alternative assets that are substantially the same as the real estate asset readily available in the marketplace (see paragraph 9.1.50), and will always result in a failed sale/purchase in a sale-leaseback transaction. [ASU 2016-02.BC352(c)]



### Question 9.1.40

#### Assessing whether assets are 'substantially the same'

**What does 'substantially the same' mean?**

**Background:** For a seller-lessee repurchase option with an exercise-date fair value strike price to *not* preclude sale accounting, there must be alternative assets, substantially the same as the underlying asset, readily available in the marketplace (see paragraph 9.1.50).

**Interpretive response:** As discussed in Question 9.1.30, when applying the criterion described in paragraph 9.1.50, no two *real estate* assets are considered to be substantially the same. [ASU 2016-02.BC352(c)]

For non-real estate assets, we believe 'substantially the same' is a high threshold. An asset that is merely 'similar' to another asset is not substantially the same as that asset. Judgment will be required to determine whether two non-real estate assets are substantially the same, but in general we believe those two assets will have to be nearly identical – e.g. for a piece of equipment, one that is of the same make and model, and manufactured at or near the same time.



### Question 9.1.45

#### Repurchase option for which the exercise price can exceed then-current fair value

### Does a repurchase option preclude sale/purchase accounting if the repurchase price can exceed the then-current fair value of the asset?

**Background:** Paragraph 9.1.50 outlines that a seller-lessee repurchase option does not preclude sale/purchase accounting if both: [\[842-40-25-3\]](#)

- it is exercisable only at the fair value of the asset on the exercise date ('then-current fair value'); and
- there are alternative assets, substantially the same as the transferred asset, readily available in the marketplace.

When both of these conditions exist, the buyer-lessor is *not* constrained in its ability to direct the use of and obtain substantially all the remaining benefits from the asset – i.e. it still obtains control of the asset. This is because the buyer-lessor could use the fair value proceeds from the repurchase to acquire a substantially equivalent asset in the marketplace. [\[IASU 2016.02.BC352\(c\)\]](#)

Given this, the question then arises about whether a repurchase option for which the exercise price can *exceed*, but not be less than, then-current fair value precludes sale/purchase accounting given the explicit guidance in paragraph 842-40-25-3.

For example, consider a sale-leaseback arrangement for a piece of equipment with an unrelated buyer-lessor that includes both:

- an option for the seller-lessee to repurchase the equipment at the end of the lease term at its then-current fair value; and
- a seller-lessee guarantee of the residual value of the equipment at the end of the lease term.

The combination of these two clauses means that if the fair value of the equipment at the end of the lease term is less than the guaranteed residual value, the seller-lessee must pay the greater guaranteed residual amount to reacquire the equipment. In this example, the specific question, assuming there are no other impediments to a successful sale/purchase, is whether these two clauses together preclude sale/purchase accounting.

**Interpretive response:** No. As outlined above, when the two criteria in paragraph 9.1.50 are met, the buyer-lessor obtains control of the underlying asset despite the repurchase option. The buyer-lessor can either:

- use the fair value proceeds from the seller-lessee's repurchase to acquire a substantially equivalent asset that is readily available in the marketplace; or
- acquire an equivalent asset to deliver to the seller-lessee for which it will receive equal compensation in the form of seller-lessee fair value payment.

Still assuming there are substantially equivalent assets readily available in the marketplace, a seller-lessee repurchase option that can only pay the buyer-lessor *more than* the then-current fair value of the underlying asset does not

negate the buyer-lessor's ability to undertake either of the options in the preceding paragraph. For example, if the then-current fair value of the asset is \$100, but the seller-lessee must pay the buyer-lessor \$105, the buyer-lessor can still use \$100 of the \$105 in proceeds to effect either option.

Therefore, we believe a repurchase option that can only be exercised at *or above* then-current fair value does not prevent the buyer-lessor from obtaining control of the underlying asset, and consequently does not preclude sale/purchase accounting when there are substantially equivalent assets readily available in the marketplace.

In contrast, a repurchase option that could result in the seller-lessee paying *less than* then-current fair value, however unlikely that outcome might be, always precludes sale/purchase accounting, and therefore results in a failed sale/purchase.



### Question 9.1.50

#### **Seller-lessee's right of first offer**

### **Under what circumstances would a right of first offer by a seller-lessee preclude sale-leaseback accounting?**

**Background:** A sale-leaseback agreement may include a provision that allows the seller-lessee to make an offer to repurchase the asset before the buyer-lessor obtains offers from third parties, commonly referred to as a right of first offer.

**Interpretive response:** We believe a right of first offer would preclude sale accounting in a sale-leaseback transaction if either (1) the buyer-lessor is economically or contractually compelled to accept the seller-lessee's offer or (2) the seller-lessee is economically or contractually compelled to make an offer.

In the case of (1), the right of first offer is effectively a repurchase option for the seller-lessee, which precludes sale and leaseback accounting in all cases if the underlying asset is real estate (see Question 9.1.30) and precludes sale-leaseback accounting in all other cases unless the criteria described in paragraph 9.1.50 are met.

In the case of (2), the right of first offer is effectively a forward. Consequently, a sale/purchase does not occur because, in accordance with the repurchase agreements implementation guidance in Topic 606, the buyer-lessor does not obtain control of the underlying asset. [606-10-55-68]

We believe an entity's analysis of contractual compulsion should consider the enforceable rights and obligations of the contract. In cases of significant uncertainty about enforceability, the entity may need legal interpretation by qualified counsel.

Meanwhile, we believe an entity's analysis of economic compulsion should consider all relevant economic factors, including those that are contract-based, asset-based, market-based and entity-based. We believe these factors

would generally be consistent with those for assessing lessee options to extend or terminate a lease or purchase the underlying asset (see paragraph 5.2.60).

We believe a right of first offer is neither an obligation nor an option to repurchase the underlying asset if (1) the buyer-lessor is not economically or contractually compelled to accept the seller-lessee's offer, and (2) the seller-lessee is not economically or contractually compelled to make an offer. Absent a conclusion that a right of first offer is in substance a repurchase option or a repurchase obligation, the right of the seller-lessee to make an *offer* to repurchase the underlying asset from the buyer-lessor, which the buyer-lessor can refuse (both legally and constructively), does not, by itself, prevent the buyer-lessor from obtaining control over the underlying asset in accordance with paragraph 842-40-25-1.



## Observation

### **Approach to repurchase options different from Topic 606**

9.1.110 The Board's decision to permit sale/purchase accounting in a sale-leaseback transaction when the seller-lessee has a repurchase option in limited circumstances appears to be a departure from the Board's stated aim of recognizing a sale/purchase only when the requirements for a sale in Topic 606 are met. This is because Topic 606 precludes accounting for a transaction as a sale if the seller has any substantive option to repurchase the good sold, regardless of the strike price or the nature of the good, i.e. whether or not there are alternative assets substantially the same as the transferred asset readily available in the marketplace. [IASU 2016-02.BC352(c)]

9.1.120 The Board's decision to permit sale/purchase accounting in those limited circumstances reflects the discomfort that some Board members had with a seller-lessee recognizing a liability for the consideration received from the buyer-lessor solely because it has the option to reacquire the asset and may only do so by paying its fair value when the option is exercised. Other Board members, when reaching this decision, noted that a repurchase option permitting the seller to repurchase an asset that is readily available in the marketplace at its then-prevailing fair value does not constrain a customer in its ability to direct the use of, and obtain substantially all the benefits from, the asset. [IASU 2014-09.BC425]

9.1.130 If a contract exists and the buyer-lessor obtains control of the underlying asset, the transaction is accounted for as a sale and a leaseback by both the seller-lessee and the buyer-lessor. [842-40-25-4]

9.1.140 If the transfer of the asset to the buyer-lessor does not meet the criteria to be accounted for as a sale, both parties to the transaction account for the transfer of the underlying asset as a financing arrangement – i.e. as a 'failed sale' by the seller-lessee, and as a 'failed purchase' by the buyer-lessor. The accounting for failed sale-leaseback transactions is discussed in section 9.3. [842-40-25-5]

9.1.150 In some cases, an entity enters into a sale-leaseback transaction in which the asset is either: [842-40-55-18]

- subject to an existing operating lease; or
- subleased or intended to be subleased by the seller-lessee to another entity under an operating lease – i.e. the entity is or will be a sublessor.

9.1.160 The existence of a sublease does not, by itself, prevent the buyer-lessor from obtaining control of the asset – i.e. from concluding that a sale/purchase has occurred and also does not prevent the seller-lessee from controlling the asset before its transfer to the buyer-lessor. The seller-lessee is subject to the same requirements for determining whether the transfer of the asset is a sale with or without the sublease. [842-40-55-19]

9.1.170 A seller-lessee residual value guarantee of the transferred asset does not automatically preclude a conclusion that a sale/purchase has occurred. However, a seller-lessee residual value guarantee may suggest that the buyer-lessor has not taken on the significant risks and rewards of ownership of the asset, which is one of the indicators to consider, together with the control principle, when evaluating whether a customer has obtained control of an asset in Topic 606 (see paragraph 9.1.40). [842-40-55-21, 606-10-25-30]



### Question 9.1.60

#### Limitations of risk related to the underlying asset

## Do guarantees or indemnities provided by the seller-lessee to the buyer-lessor affect whether a sale-leaseback transaction meets the criteria for sale/purchase accounting?

**Background:** The seller-lessee in a sale-leaseback transaction will frequently provide guarantees or indemnities to the buyer-lessor, or arrange for a third party to do so – e.g. through insurance that the seller-lessee purchases. For example, these may include one or more of the following (not exhaustive):

- a residual value guarantee related to the underlying asset;
- indemnifying the buyer-lessor for environmental conditions that existed before the asset is transferred to the buyer-lessor;
- indemnifications with respect to preexisting tax liabilities related to the underlying asset; and/or
- indemnifications against other contingent losses.

**Interpretive response:** In general, no. The provision of a guarantee or indemnification typically does not, by itself, preclude a sale-leaseback transaction from meeting the criteria for sale/purchase accounting under Subtopic 842-40.

Whether or not a transaction qualifies for sale/purchase accounting depends on whether *control* of the underlying asset transfers to the buyer-lessor. Control, in the context of the sale of an asset (see paragraph 9.1.30), refers to the ability of the buyer-lessor to direct the use of, and obtain substantially all the remaining benefits from, the asset. [606-10-25-25]

Having the significant risks and rewards of ownership is only one indicator to be considered in determining when control of the asset transfers to the buyer-lessor. However, we believe the definition of control suggests that the absence of exposure to significant risks (e.g. because of a seller-lessee guarantee or an indemnification) will typically not, in isolation, affect whether the buyer-lessor has the present ability to direct the use of, and obtain substantially all the remaining benefits from, the asset. [606-10-25-25, 25-30]

For example, a residual value guarantee, or an indemnification against environmental claims or future clean-up costs, even if significant, would typically not prevent the buyer-lessor from being able to direct the use of, and obtain substantially all the remaining benefits from, the asset in the same manner as a typical lessor *not* involved in a sale-leaseback transaction (see paragraphs 9.1.70 – 9.1.90).

All terms and conditions surrounding the guarantee or indemnification should be considered. If, as a condition of providing the guarantee or indemnification, the buyer-lessor forfeits substantial rights that a 'normal' lessor would typically control, it may not obtain control of the asset. For example, if the buyer-lessor commits not to sell the asset, even subject to the leaseback, or lease it to competitors of the seller-lessee at the end of the leaseback term, one might conclude the buyer-lessor does not obtain the ability to direct the use of the asset. Similarly, if the buyer-lessor agrees to provide all (or substantially all) of any variable upside to the seller-lessee if it resells the asset, that may suggest the buyer-lessor does not have the right to obtain substantially all the remaining benefits from the asset.

Regardless of its effect on the sale/purchase accounting conclusion, the seller-lessee will need to consider whether Topic 460 (guarantees) applies, such as for guarantees other than a residual value guarantee of the underlying asset. The fair value of a Topic 460 guarantee will affect the allocation of the transaction price to the sale in a successful sale-leaseback because a portion of the transaction price will be allocated to the guarantee. [460-10-15-7(b), 606-10-15-2, 15-4]



## Question 9.1.70

### Conflicting transfer of control indicators

**How should an entity evaluate whether a sale/purchase has occurred in a sale-leaseback transaction when the transfer of control indicators provide conflicting evidence?**

**Background:** The transfer of control indicators in paragraph 606-10-25-30 will almost always provide conflicting evidence in a sale-leaseback transaction. The buyer-lessor will typically obtain title to, and have a present obligation to pay the seller-lessee for, the asset; however, the seller-lessee typically retains physical possession of the asset. The indicator about customer acceptance will frequently not apply. Consequently, the indicator that the 'customer has the significant risks and rewards of ownership of the asset' may often receive

significant attention in the evaluation, because it is the indicator that may most likely vary from transaction to transaction. For example, a significant seller-lessee residual value guarantee of the asset may suggest that the buyer-lessor does not have the significant risks *and* rewards of ownership of the asset. In that case, the control indicators would be split. [IAS 2016-02.BC353]

**Interpretive response:** When evaluating whether a sale/purchase occurs in a sale-leaseback transaction, it is important to remember that the indicators should be considered *together with*, and *in the context of*, the control principle – which is that control refers to the ability to direct the use of, and obtain substantially all the remaining benefits from, an asset (see paragraph 9.1.30). [606-10-25-25, 25-30]

Therefore, if the control indicators conflict, more weight should be given to information that provides evidence about whether the buyer-lessor has the ability to direct the use of, and obtain substantially all the remaining benefits from, the asset.

For example, as indicated in Question 9.1.60, guarantees or indemnifications may reduce the risk the buyer-lessor assumes in the asset, but that mitigation of risk may have little relevance to whether the buyer-lessor *controls* the asset. In contrast, the buyer-lessor having valid title to the asset may directly affect whether the buyer-lessor can direct the use of the asset (e.g. sell the asset or enter into an enforceable forward-starting lease) and obtain its remaining benefits (e.g. sell the asset, subject to the leaseback, to take advantage of an increase in its market value).



### Example 9.1.10

#### Determining whether a sale/purchase has occurred

Seller-Lessee SL enters into a contract (that meets the contract existence criteria in Topic 606) with Buyer-Lessor BL for the sale-leaseback of a machine. The machine has a remaining economic life of five years, and its fair value is \$100,000. Title to the machine transfers to BL, and the transaction price for the machine is payable to SL at commencement of the leaseback.

#### Scenario 1: Seller-lessee repurchase option does not preclude sale/purchase accounting

In addition to the basic facts, the following facts are relevant.

Leaseback term:	3 years
Leaseback payments:	Fixed payments of \$28,000 per year in arrears
SL's incremental borrowing rate <sup>1</sup> :	7%
Expected residual value:	\$30,000
RVG:	None
Purchase option:	Fair value of machine at date of exercise

Note:

1. The rate implicit in the lease is not readily determinable.

In addition:

- The machine is produced widely so alternative machines, substantially the same as the transferred machine, are readily available in the marketplace.
- The leaseback would not be classified as a finance lease by SL, or as a sales-type lease by BL, applying the relevant criteria for lease classification in section 6.2 (lessees) and section 7.2 (lessors).

Both SL and BL conclude that the transaction qualifies for sale/purchase accounting for the machine on the basis that BL obtains rights to control the machine that are generally consistent with that of any other lessor (see paragraphs 9.1.70 – 9.1.90). Further, neither of the specific exclusions to accounting for the transaction as a sale/purchase exist:

- The leaseback would not be classified as a finance/sales-type lease; and
- SL's repurchase option does not preclude sale/purchase accounting, because:
  - The strike price is the fair value of the machine on the exercise date; and
  - There are alternative machines, substantially the same as the transferred machine, readily available in the marketplace.

Lastly, the transfer of control indicators in Topic 606 also support that control of the asset transfers to BL at commencement of the leaseback. This is because, even though SL retains physical possession of the machine, the following occur at commencement:

- title transfers to BL;
- SL has a present right to payment of the transaction price for the machine; and
- BL assumes the significant risks and rewards of ownership – e.g. BL is now at risk for (or will benefit from) changes in the residual value of the transferred machine.

### **Scenario 2: Seller-lessee repurchase option results in failed sale/purchase**

Assume the same as in Scenario 1, except that the machine has been designed and modified specifically for Seller-Lessee SL's commercial needs. Therefore, there are no alternative assets substantially the same as the transferred machine readily available in the marketplace.

In this scenario, the transaction does not qualify for sale/purchase accounting. SL's repurchase option precludes sale/purchase accounting for both SL and Buyer-Lessor BL.

In addition, while assumed not to be the case in this scenario, in a similar scenario the specialized design and modification of the machine could lead to a conclusion that the machine will have no alternative use to BL at the end of the leaseback term, and therefore the leaseback is a finance/sales-type lease (also resulting in a failed sale/purchase).

### Scenario 3: Seller-lessee residual value guarantee

Assume the same facts as in Scenario 1, except that:

- Seller-Lessee SL guarantees \$20,000 of the expected \$30,000 residual value of the machine; and
- SL does not have a repurchase option.

Consistent with Scenario 1, even though SL retains physical possession of the machine, the following occur at commencement:

- title transfers to Buyer-Lessor BL; and
- SL has a present right to payment.

These indicators provide evidence that BL has obtained control of the machine. However, SL retains physical possession of the machine, and the significant residual value guarantee provided by SL calls into question whether BL has the significant risks and rewards of ownership, which both indicate that control may not have transferred to BL. While BL can potentially obtain the rewards of ownership, the residual value guarantee substantially limits BL's risk. Because of the conflicting control indicators, there is judgment in determining whether control of the machine transfers to BL at commencement of the leaseback.

In this scenario, both SL and BL determine that the transaction qualifies for sale/purchase accounting. They base their conclusions on the following:

- BL can direct the use of the machine in the same way that any other lessor can direct the use of an asset subject to a lease – e.g. it can sell the asset (subject to the leaseback); and
- BL can obtain substantially all of the remaining benefits related to the machine – i.e. it is entitled to either the entirety of the proceeds from a sale, or to the cash payments from the leaseback and the residual benefits of the machine after the leaseback term.

### Scenario 4: Leaseback is a finance/sales-type lease

Assume the same facts as in Scenario 1, except that the leaseback term is four years.

Because the leaseback term is for the major part of the remaining economic life of the machine (four-year lease term compared to five-year remaining economic life), the leaseback would be classified as a finance lease by Seller-Lessee SL, and as a sales-type lease by Buyer-Lessor BL. Therefore, the transaction does not qualify for sale (from the perspective of SL) or purchase (from the perspective of BL) accounting. Instead, both parties will account for the transaction as a financing arrangement (see section 9.3).



### Question 9.1.80

#### Seller-lessee participation in buyer-lessor financing

**Does seller-lessee participation in the financing of the buyer-lessor affect whether a sale-leaseback transaction qualifies for sale/purchase accounting?**

**Background:** A buyer-lessor may obtain financing from a third party to purchase the underlying asset from the seller-lessee, and the seller-lessee may participate in that financing. For example, the seller-lessee may provide a financial guarantee or indemnification to the financing party, establish the creditworthiness of the buyer-lessor to the financing party, or furnish a letter of credit to the financing party where the seller-lessee's leaseback is an integral part of the financing party's decision to provide financing to the buyer-lessor.

**Interpretive response:** It depends. In general, the seller-lessee providing a guarantee of the buyer-lessor's debt (or otherwise participating in the buyer-lessor's financing), by itself, does not affect whether the buyer-lessor obtains control of the underlying asset (see Question 9.1.60). That is, absent other provisions, the guarantee alone would not prevent the buyer-lessor from having the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset in the same manner as any other lessor that acquires an asset to lease to a third party (see paragraphs 9.1.70 – 9.1.90) – e.g. the guarantee alone would not prohibit the buyer-lessor from selling the asset (subject to the leaseback), or entering into an arrangement such as a forward-starting lease, and realizing the remaining benefits from the asset as a result. This is true even if the effect of the guarantee is that the buyer-lessor has not taken on the significant risks of ownership of the asset.

The parties would, however, need to consider whether other terms and conditions associated with inducing the seller-lessee to provide the guarantee or otherwise participate in the financing prevent the buyer-lessor from obtaining control of the asset. For example, if, as a condition of providing a loan guarantee, the buyer-lessor is not permitted to sell the underlying asset (even subject to the leaseback) during the leaseback period, that may suggest the buyer-lessor does not have the ability to direct the use of, or obtain substantially all the remaining benefits from, the asset until the leaseback expires.

A guarantee of the buyer-lessor's debt is generally excluded from the leaseback payments (unless the guarantee is in substance a residual value guarantee – see Question 5.4.100), but would still need to be considered under Topic 460. If the guarantee is in the scope of Topic 460, the fair value of the guarantee will reduce the amount of the transaction price that is allocated to the sale of the asset – i.e. the fair value of the guarantee is carved out from the transaction price and allocated to the guarantee. [842-10-30-6(b)]

The following are additional considerations related to a financial guarantee provided by the seller-lessee.

- If the financial guarantee is not in the scope of Topic 460 (and is not in substance a residual value guarantee of the transferred asset), the seller-

lessee may be induced to grant a concession to the buyer-lessor that might be considered a reduction of the transaction price for the sale. For example, to avoid having to perform under the guarantee, the seller-lessee might accelerate or increase the leaseback payments. Such concessions, if reasonably possible when the asset is sold to the buyer-lessor, would generally create variable consideration in the transaction price for the sale (which would need to be estimated up-front subject to the variable consideration constraint – see paragraph 9.2.10). If concessions occur, but were not expected at contract inception, significant judgment may be required to determine whether such actions affect the transaction price for the sale or, instead, modify the leaseback.

- If the buyer-lessor is a vendor to the seller-lessee (or vice versa), the seller-lessee's guarantee of the buyer-lessor's debt may induce either party to grant the other concessions in a revenue transaction. For example, the buyer-lessor may grant a concession if it is the vendor because of the guarantee and the seller-lessee may grant a concession if it is the vendor because it doesn't want to risk having to perform under the guarantee. A reasonable expectation of any such concessions would be treated as variable consideration in the revenue contract(s) between the parties.



### Question 9.1.90

#### **Seller-lessee's ability to share in income or profits**

#### **Do income- or profit-sharing provisions preclude accounting for the transfer of an asset as a sale/purchase in a sale-leaseback transaction?**

**Interpretive response:** It depends. The right of the seller-lessee to share in future income (e.g. the profit from a follow-on sale of the asset or income earned from developing previously undeveloped land) will generally not affect the buyer-lessor's ability to direct the use of the asset. For example, such a provision will not, by itself, affect whether the buyer-lessor can exercise rights to direct the use of the asset consistent with those of any other lessor, such as being able to sell the asset (subject to the lease) (see paragraphs 9.1.70 – 9.1.90).

However, depending on the terms and conditions, a profit-sharing provision may preclude the buyer-lessor from obtaining substantially all the remaining benefits from the asset.

In general, we believe a profit-sharing provision would not preclude the buyer-lessor from obtaining substantially all of the remaining benefits from the asset if it merely permits the seller-lessee (or a related party) to participate in the future income.

For example, if the seller-lessee is entitled to a percentage of any profit the buyer-lessor earns from selling the asset to a third party or to a percentage of the income earned from developed property, we believe the buyer-lessor still

has the right to obtain substantially all of the remaining benefits from the asset, and the portion it must pay to the seller-lessee is similar to paying a percentage of a leased retail store's sales to the lessor. In that case, the Board concluded that a requirement for the lessee to remit a portion of the economic benefits it obtains from use of the asset to the lessor does not mean that it does not obtain substantially all the economic benefits from use of the asset. Similarly, the requirement for a customer to pay a sales- or usage-based royalty to the seller of an asset does not, by itself, preclude a sale under Topic 606 or Topic 610 (other income). [842-10-15-19]

In contrast, if the income share in effect grants all or substantially all of the upside benefit to the seller-lessee (or a related party), that would indicate the buyer-lessor does *not* have the right to substantially all the remaining benefits from the asset. The following are examples that we believe will typically indicate that the buyer-lessor has not obtained substantially all the economic benefits from use of the asset (not exhaustive).

- The seller-lessee is entitled to all or substantially all of any profit from a subsequent sale of the asset.
- The seller-lessee is entitled to all or substantially all of any profit from a subsequent sale of the asset that exceeds a specified amount where there is a reasonable likelihood that amount will be significantly exceeded if a sale occurs.
- The seller-lessee is entitled to receive the variable expected benefits from development of an undeveloped asset, while the buyer-lessor's return is fixed – i.e. substantially in the manner of a service fee.



### Question 9.1.100

#### Different conclusions by the seller-lessee and buyer-lessor

#### Will a seller-lessee and a buyer-lessor reach the same conclusions about whether a sale/purchase has occurred in the context of a sale-leaseback transaction?

**Interpretive response:** Not always. It is possible that a seller-lessee and a buyer-lessor in a sale-leaseback transaction will not come to the same conclusions about whether a sale/purchase occurs. This could result for any of the following reasons (not exhaustive). [606-10-25-25, 25-30]

- Different judgments or estimates (e.g. discount rate for the lease) result in the two entities reaching different conclusions about whether the leaseback would be classified as a finance lease (lessee) or a sales-type lease (lessor).
- Different judgments about the nature of the asset (e.g. whether assets substantially the same as the transferred assets are readily available in the marketplace) could result in different conclusions about the effect of a seller-lessee repurchase option with a fair value strike price.

- Different evaluations of the control guidance – i.e. the indicators and the definition of control.
- Effect of variable lease payments on buyer-lessor lease classification – i.e. variable leaseback payments may require the buyer-lessor to classify the leaseback as an operating lease even though the lessee would classify it as a finance lease (see paragraph 7.2.30).



### Question 9.1.110

#### **Unit of account for determining whether a sale/purchase has occurred**

### **What is the unit of account for determining whether a sale/purchase has occurred in a sale-leaseback transaction?**

**Interpretive response:** Each transferred asset is its own unit of account for purposes of determining whether a sale/purchase has occurred. Only after it has been determined that a sale/purchase has occurred, and therefore that there is a leaseback, does the entity determine whether multiple transferred and leased back assets constitute a single separate lease component (see section 4.1). [842-40-25-1, 25-4]

This means that if two assets (e.g. a building and land) are transferred in a sale-leaseback transaction, even if the two leases would be accounted for as a single separate lease component, sale/purchase determination occurs at the individual asset level. Therefore, it is possible that one asset fails sale accounting (e.g. because it is subject to a non-exempt repurchase option – see paragraph 9.1.50) but the other does not, even though the two leasebacks would have been accounted for as a single separate lease component if both had been successfully sold.

Consistent with the discussion in Question 3.2.10 related to lease identification, an entity does not break apart a single, integrated asset (e.g. an airplane or a ship) and evaluate whether a sale/purchase has occurred separately for the assets combined to create the single integrated asset.



### Comparison to legacy US GAAP

#### **New control-based sale determination aligns with Topic 606 and differs substantially from Topic 840**

9.1.180 The control-based model for determining whether a sale has occurred in the context of a sale-leaseback transaction differs from the risks and rewards-based model applied to sale-leasebacks of equipment and the prescriptive, continuing involvement model applied to sale-leasebacks of real estate under Topic 840. Under Topic 842, risks and rewards of ownership is just one of five indicators, applied together with the control principle, used in determining whether control of an asset has transferred from the seller-lessee to the

buyer-lessor. In addition, the continuing involvement guidance that existed in Topic 840 has been superseded.

9.1.190 As outlined in Question 9.1.70, it is important to evaluate the control principle, not solely the control indicators, and apply more weight to those indicators and other evidence that provide relevant information about whether the buyer-lessor obtains control of the underlying asset. In particular, the Topic 840 guidance placed significant weight on which party had exposure to various risks of ownership; and as discussed in Question 9.1.60, risk exposure will typically not affect whether 'control' of the asset transfers to the buyer-lessor.

### **Different sale-leaseback accounting for real estate vs. other assets eliminated**

9.1.200 Topic 840 had different guidance for sale-leaseback transactions of real estate versus other assets. Under Topic 842, the same guidance applies to all sale-leaseback transactions, regardless of whether the underlying asset is real estate. [840-40-25-9 – 25-18]

### **Sale-leaseback accounting now easier to achieve for real estate; more difficult for other assets**

9.1.210 Sale-leaseback transactions in the US involving equipment often contain an option for the seller-lessee to repurchase the equipment. Such options generally did not result in a failed sale under Topic 840 unless the repurchase option was a bargain repurchase option. Topic 842 makes it more difficult for many equipment sale-leaseback transactions to qualify for sale-leaseback accounting. [840-40-25-13(a)]

9.1.220 Conversely, Topic 840 resulted in a failed sale for real estate sale-leaseback transactions if the seller-lessee had continuing involvement (including a repurchase option at any strike price) with the real estate other than a normal leaseback. Failed sales were common in real estate sale-leaseback transactions as a result. Because Topic 842 supersedes the continuing involvement provisions that existed in Topic 840, it is generally easier for real estate sale-leaseback transactions to qualify for sale-leaseback accounting under Topic 842 than it was under Topic 840. However, a seller-lessee repurchase option still precludes sale-leaseback accounting for a real estate sale-leaseback transaction (see Question 9.1.30). [840-40-25-9 – 25-18]

### **Continuing involvement questions under legacy US GAAP**

9.1.230 Over time, many questions (often highly specific) arose in practice about how to apply the continuing involvement provisions in Topic 840. Most of those questions are no longer relevant under Topic 842 as a result of eliminating the continuing involvement provisions and because determining whether a sale/purchase occurs is now subject to the new control principle that did not previously exist for real estate or equipment sale-leaseback transactions. Most of the specific items that affected whether a sale occurred in the context of the continuing involvement guidance in Topic 840 no longer have a specific effect on the sale/purchase accounting conclusion under Topic 842.

### New 'failed purchase' accounting

9.1.240 When the transfer of the asset does not qualify for sale/purchase accounting based on the relevant guidance in Topic 606, Topic 842 requires the buyer-lessor to account for a sale-leaseback transaction as a 'failed purchase' (see section 9.3). In contrast, Topic 840 never required the buyer-lessor to account for a failed purchase, even if the seller-lessee accounted for the transaction as a failed sale.

### Prohibition on sale-leaseback accounting for capital (finance) leasebacks

9.1.250 Topic 840 did not prohibit sale-leaseback accounting by a seller-lessee solely because the seller-lessee classified the leaseback as a capital lease.  
[\[840-40-25-2\]](#)

## 9.2 Accounting for sale-leaseback transactions



### Excerpt from ASC 842-40

#### 25 Recognition

##### General

> Transfer of the Asset Is a Sale

**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.

#### 30 Initial Measurement

##### General

> Transfer of the Asset Is a Sale

**30-1** An entity shall determine whether a sale and leaseback transaction is at **fair value** on the basis of the difference between either of the following, whichever is more readily determinable:

- a. The sale price of the asset and the fair value of the asset
- b. The present value of the **lease payments** and the present value of market rental payments.

**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.

**30-3** A sale and leaseback transaction is not off market solely because the sale price or the lease payments include a variable component. In determining whether the sale and leaseback transaction is at fair value, the entity should consider those variable payments it reasonably expects to be entitled to (or to make) on the basis of all of the information (historical, current, and forecast) that is reasonably available to the entity. For a seller-lessee, this would include estimating any variable consideration to which it expects to be entitled in accordance with paragraphs 606-10-32-5 through 32-9.

**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.

**30-5** See Examples 1 and 2 (paragraphs 842-40-55-22 through 55-38) for illustrations of the requirements for a sale and leaseback transaction.

## 55 Implementation Guidance and Illustrations

### General

- > Implementation Guidance
- > Sale Subject to a Preexisting Lease

**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.

**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.

9.2.10 When a sale/purchase occurs in the context of a sale-leaseback transaction, at the point in time that the buyer-lessor obtains control of the asset (under Topic 606), the seller-lessee: [842-40-25-4(a), 606-10-25-30, 32-2 – 32-27]

- recognizes the transaction price (i.e. the sales price) based on the guidance on determining the transaction price in Topic 606, adjusted for any off-market terms; and
- derecognizes the carrying amount of the underlying asset.

9.2.20 Subject to any adjustment for off-market terms, this results in recognition of the full amount of the gain or loss on the sale of the asset.

9.2.30 A seller-lessee accounts for the leaseback under the lessee accounting model (see chapter 6). [842-40-25-4(a)(3)]

9.2.40 A buyer-lessor accounts for the: [842-40-25-4(b)]

- purchase of the underlying asset in a sale-leaseback transaction consistent with the guidance that would apply to any other purchase of a nonfinancial asset (subject to any off-market adjustment) – i.e. without the presence of a leaseback; and
- leaseback under the lessor accounting model (see chapter 7).



### Question 9.2.05

#### Presentation of a sale-leaseback in the income statement

**How does a seller-lessee present the sale of the asset in a sale-leaseback in the income statement if it sells similar assets as part of its ordinary activities?**

**Interpretive response:** If sales of similar assets to those sold in the sale-leaseback transaction are part of the seller-lessee's 'ordinary activities', the buyer-lessor is a customer of the seller-lessee. For a discussion of ordinary activities, see section 2.2.10 of KPMG Handbook, [Revenue recognition](#).

In that case, we believe the seller-lessee should account for the sale under Topic 606, and present the sale consistent with its other sales of similar assets. This would likely result in accounting for the sale proceeds as revenue from

contracts with customers, and the cost basis of the transferred asset derecognized as cost of goods sold. See note at the end of Example 9.2.10.

### 9.2.1 Determining whether the sales price is off-market

9.2.50 Unless the sale-leaseback transaction is between related parties (see paragraph 9.2.100), the sale/purchase is accounted for at fair value. Therefore, both the seller-lessee and the buyer-lessor need to assess whether the transaction is at fair value – i.e. at market terms. [842-40-30-1]



#### Observation

**Gain recognition consistent with that for any nonfinancial asset**

9.2.60 The Board concluded that if the sale and the leaseback are at market terms, the transfer of control of the asset (i.e. the sale) to the buyer-lessor is separate and distinct from the buyer-lessor's transfer of a right to use that asset to the seller-lessee. Consequently, the presence of the leaseback should neither preclude the sale of the asset, nor alter the accounting for that sale (except as necessary to adjust for off-market terms). [ASU 2016-02.BC359–BC360]

9.2.70 In assessing whether the transaction is at fair value, an entity uses the formula that is more readily determinable: [842-40-30-1]

- the sales price of the asset versus the fair value of the asset; or
- the present value of the lease payments versus the present value of market rental payments.



#### Question 9.2.10

**Which formula to apply**

**Will the two permissible formulas for assessing whether a sale-leaseback transaction is at fair value yield the same result, and if not, is the selection of which formula to use an option?**

**Interpretive response:** The two formulas for determining whether the transaction is at fair value may yield different results. Despite that fact, the Board decided that either comparison could be an acceptable way to identify whether the accounting for the transaction needs to be adjusted for off-market terms.

The decision about which formula to use when evaluating a given transaction is neither a 'free choice' nor an accounting policy election applied to all sale-leaseback transactions. Rather, for each sale-leaseback transaction, an entity is

required to maximize the use of observable prices and information, which may mean an entity uses the first formula in paragraph 9.2.70 for some transactions and the second formula in paragraph 9.2.70 for others. Maximizing the use of observable prices and information is consistent with using the comparison that is more readily determinable. [ASU 2016-02.BC363-BC364]

9.2.80 A sale-leaseback transaction is not off-market solely because the sales price or the leaseback payments include a significant variable component. In determining whether the sales price is at fair value, the entity considers those variable payments that it reasonably expects to receive (or make) on the basis of all reasonably available information (e.g. historical, current, and/or forecasted). For the seller-lessee, this includes estimating variable consideration to which it expects to be entitled under the guidance on estimating variable consideration (excluding the constraint on variable consideration) in Topic 606. [842-40-30-3, 606-10-32-5 – 32-9]

9.2.90 Sale-leaseback transactions are generally interdependent and negotiated as a package. Consequently, the parties could negotiate off-market terms for either the sale or the leaseback, and recoup the difference through the other part of the transaction – i.e. through a negotiated sales price above fair value and lease payments above market rates, or vice versa.

9.2.100 If the sale-leaseback transaction is between related parties, neither the seller-lessee nor the buyer-lessor adjusts for off-market terms. Instead, the entity discloses the off-market nature of the transaction (see paragraph 12.2.20). [842-40-30-4]



### Observation

#### **Accounting for related party transactions based on contractual terms**

9.2.110 The Board decided that recognizing sale-leaseback transactions between related parties based on the enforceable terms and conditions is consistent with its corresponding decision for related party leases in general. In both cases, the Board concluded that an entity should not account for the transaction in accordance with a subjective determination of its economic substance. [ASU 2016-02.BC362]

## 9.2.2

### **Adjusting the gain or loss for off-market terms**

9.2.120 If, based on the evaluation in section 9.2.1, the sale-leaseback transaction is not at fair value, the entity (whether the seller-lessee or the buyer-lessor) adjusts the sales price so that the transaction is recognized at fair value: [842-40-30-2]

- **Deficit.** If the sales price is less than fair value, an adjustment is made to increase the sales price of the asset. The corresponding debit is recognized as a rent prepayment.

- **Excess.** If the sales price is greater than fair value, an adjustment is made to decrease the sales price of the asset. The corresponding credit is recognized as additional financing provided by the buyer-lessor to the seller-lessee.

9.2.130 When the sales price exceeds fair value, and additional financing is recognized, both the seller-lessee and the buyer-lessor allocate a portion of each contractual lease payment to both the lease and the additional financing.  
[\[842-40-30-2, 55-23 – 55-30\]](#)

- The amount allocated to each by the seller-lessee is the amount necessary to ensure that the lease liability and the additional financial liability both equal zero at the end of the leaseback term.
- The amount allocated to each by the buyer-lessor is the amount necessary to reduce its financial asset and net investment in a direct financing leaseback to zero at the end of the leaseback term.

9.2.140 Operating lease cost (seller-lessee) or income (buyer-lessor) is determined based on the total amount of the contractual payments allocated to the lease.

### 9.2.3 Accounting for the leaseback

9.2.150 When a sale-leaseback transaction results in a sale/purchase, both the seller-lessee and the buyer-lessor account for the leaseback in the same manner as any other lease – see chapter 6 (lessees) and chapter 7 (lessors).  
[\[842-40-25-4\]](#)



#### Example 9.2.10

#### Gain recognized by seller-lessee in a sale-leaseback transaction

Seller-Lessee SL sells a building to Buyer-Lessor BL and leases it back. The following facts are relevant at the point in time that BL takes control of the building:

Carrying amount of building:	\$1.5 million
Sales price (and fair value <sup>1</sup> ) of the building:	\$2.5 million
Lease term:	4 years
Lease payments:	Fixed payments of \$325,000 per year in arrears
SL's incremental borrowing rate <sup>2</sup> :	10%
Lease incentives/initial direct costs:	None

## Notes:

1. Based on recent sales prices of comparable buildings in the area, which are more readily determinable than market rentals for the four-year leaseback.
2. The rate implicit in the lease is not readily determinable (see section 5.6).

As illustrated in the following journal entries, SL recognizes the full amount of the gain on the sale of the building, consistent with how it would recognize the gain resulting from the sale of any other nonfinancial asset.

	<i>Debit</i>	<i>Credit</i>
Cash	2,500,000	
Building		1,500,000
Gain on sale <sup>1</sup>		1,000,000
<i>To recognize sale in sale-leaseback transaction.</i>		
ROU asset <sup>2</sup>	1,030,206	
Lease liability <sup>3</sup>		1,030,206
<i>To recognize leaseback in sale-leaseback transaction.</i>		

## Notes:

1. Sales price (\$2.5 million) – carrying amount of building (\$1.5 million).
2. Lease liability (\$1,030,206) + prepaid rent (nil) + initial direct costs (nil) – lease incentives (nil).
3. Four payments of \$325,000 (paid in arrears), discounted at 10%.

**Note:** If SL sells similar buildings as part of its ordinary activities, rather than recognizing a net 'gain on sale' of the building of \$1,000,000, SL would recognize \$2,500,000 in revenue from contracts with customers and \$1,500,000 as cost of goods sold.



### Example 9.2.20

#### Accounting for a sale-leaseback transaction with off-market terms

Assume the same facts as Example 9.2.10, except for the following.

- The building's observable fair value on the date of the sale is \$2 million – i.e. the sales price exceeds the building's observable fair value by \$500,000.
- The market rental payments are \$198,800 per year – i.e. the present value of the contractual lease payments exceeds the present value of market rental payments by \$400,037.
- Buyer-Lessor BL applies a discount rate of 10% to the additional financing provided to Seller-Lessee SL, determined in accordance with Subtopic 835-30 (imputation of interest).

Because the terms of the transaction are not at market, both parties record an adjustment to recognize the transaction at fair value, as an initial step in accounting for the sale-leaseback transaction.

### Seller-lessee accounting

SL uses the fair value of the asset to determine the extent to which the sale/purchase is off-market (see section 9.2.1) because the fair value of the asset is more readily determinable than market rentals for the leaseback. This means that:

- the gain on sale is calculated by reference to the fair value of \$2 million; and
- the excess of \$500,000 (\$2.5 million – \$2 million) is recognized as additional financing.

SL records the following journal entry when BL obtains control of the building.

	Debit	Credit
Cash	2,500,000	
Building		1,500,000
Financial liability <sup>1</sup>		500,000
Gain on sale <sup>2</sup>		500,000
<i>To recognize sale in sale-leaseback transaction.</i>		
ROU asset <sup>3</sup>	530,206	
Lease liability <sup>4</sup>		530,206
<i>To recognize leaseback in sale-leaseback transaction.</i>		
Notes:		
1. Contractual sales price (\$2.5 million) – fair value of building (\$2 million).		
2. Adjusted sales price (\$2 million) – carrying amount of building (\$1.5 million).		
3. Lease liability (\$530,206) + prepaid rent (nil) + initial direct costs (nil) – lease incentives (nil).		
4. \$1,030,206 (see Example 9.2.10) – off-market adjustment (\$500,000).		



### Example 9.2.30

#### Accounting for a rent-free lease in a sale-leaseback transaction

Seller-Lessee SL sells equipment with a carrying amount of \$7 million and a fair value of \$10 million to Buyer-Lessor BL in exchange for cash of \$8 million and a rent-free lease of the same equipment.

The \$2 million difference between the fair value and the sales price (the most readily determinable measure of whether the sale-leaseback transaction is off-market) represents a prepayment of the lease by SL – i.e. economically, the lease is not rent-free.

The parties record the following journal entries at the point in time BL obtains control of the equipment.

<b>BL:</b>	<i>Debit</i>	<i>Credit</i>
PP&E, net	10,000,000	
Cash		8,000,000
Deferred rent		2,000,000
<i>To record purchase of equipment.</i>		

<b>SL:</b>	<i>Debit</i>	<i>Credit</i>
Cash	8,000,000	
ROU asset (prepaid rent)	2,000,000	
Gain on sale		3,000,000
PP&E, net		7,000,000
<i>To record sale of equipment.</i>		

Subsequent to the sale, BL and SL account for the leaseback in the same manner as any other prepaid lease.



## Comparison to legacy US GAAP

### Accounting for a gain or loss on a sale-leaseback transaction

9.2.160 The requirement to recognize a gain immediately on recognition of a sale-leaseback transaction under Topic 842 is a change from Topic 840. Under Topic 840, the recognition of gain or loss on the sale of the underlying asset depended on the rights retained by the seller-lessee. These thresholds are illustrated by the following chart. [840-40-25-3 – 25-4]



9.2.170 Under Topic 840, gains or losses realized by a seller-lessee were accounted for as follows. [840-40-25-3 – 25-4]

- Transactions resulting in a realized loss by the seller-lessee:
  - Fair value of underlying asset < Carrying amount of underlying asset = Recognized the loss immediately.
  - Fair value of underlying asset > Carrying amount of underlying asset = Accounted for the loss as a prepayment of rent (i.e. deferred recognition).

- Transactions resulting in a realized gain by the seller-lessee (i.e. fair value > carrying amount):
  - When the seller-lessee retained only a minor portion of the right to the remaining use of the asset sold (i.e. < 10%), recognized the full gain immediately.
  - When the seller retained more than a minor, but less than substantially all, of the remaining use of the asset sold (i.e. between 10% and 90%):
    - **Operating leasebacks.** Recognized the gain to the extent that it exceeded the present value of the minimum lease payments. Remainder of realized gain was deferred and recognized over the leaseback term.
    - **Capital leasebacks.** Recognized the gain to the extent that the profit on the sale exceeded the carrying amount of the underlying asset on the date of sale.
- When the seller-lessee retained substantially all of the risks and benefits incidental to the ownership of the underlying asset (i.e. > 90%), profit on the sale was deferred and recognized to income over the leaseback term.

### Leaseback classification

9.2.180 Under Topic 842, a leaseback that would be classified as a finance lease by the seller-lessee or a sales-type lease (by the buyer-lessor) precludes sale/purchase accounting for the transaction. Therefore, all leasebacks are classified as an operating lease by the seller-lessee, and as an operating lease or a direct financing lease by the buyer-lessor. There were no similar prohibitions on sale-leaseback accounting based on leaseback classification under Topic 840. [840-40-25-2, 25-8]

### Related party transactions

9.2.190 Under Topic 840, entities recognized the economic substance of a related party lease rather than its legal form, which included evaluating the economic substance of sale-leaseback transactions. The requirement to evaluate related party sale-leaseback transactions solely based on their legal form is a difference between Topic 840 and Topic 842. [840-10-25-26]

## 9.3 Accounting for failed sale-leaseback transactions



### Excerpt from ASC 842-40

#### 25 Recognition

##### General

> Transfer of the Asset Is Not a Sale

**25-5** If the transfer of the asset is not a sale in accordance with paragraphs 842-40-25-1 through 25-3, both of the following apply:

- a. The seller-lessee shall not derecognize the transferred asset and shall account for any amounts received as a financial liability in accordance with other Topics.
- b. The buyer-lessor shall not recognize the transferred asset and shall account for the amounts paid as a receivable in accordance with other Topics.

### **30 Initial Measurement**

#### **General**

> Transfer of the Asset Is Not a Sale

**30-6** The guidance in paragraph 842-40-25-5 notwithstanding, the seller-lessee shall adjust the interest rate on its financial liability as necessary to ensure that both of the following apply:

- a. Interest on the financial liability is not greater than the payments on the financial liability over the shorter of the **lease term** and the term of the financing. The term of the financing may be shorter than the lease term because the transfer of an asset that does not qualify as a sale initially may qualify as a sale at a point in time before the end of the lease term.
- b. The carrying amount of the asset does not exceed the carrying amount of the financial liability at the earlier of the end of the lease term or the date at which control of the asset will transfer to the buyer-lessor (for example, the date at which a repurchase option expires if that date is earlier than the end of the lease term).

### **55 Implementation Guidance and Illustrations**

#### **General**

> Illustrations

• > Illustration of Sale and Leaseback Transaction

•• > 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-lessor; therefore, Buyer recognizes interest income on its financial asset on the basis of the imputed interest rate determined in accordance with paragraphs 835-30-25-12 through 25-13, which in this case Buyer determines to be 4 percent.

**55-34** During Year 1, Seller recognizes interest expense of \$84,600 ( $4.23\% \times \$2\text{ million}$ ) and recognizes the payment of \$200,000 as a reduction of the financial liability. Seller also recognizes depreciation expense of \$85,714 ( $\$1.8\text{ million} \div 21\text{ years}$ ). Buyer recognizes interest income of \$80,000 ( $4\% \times \$2\text{ million}$ ) 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 ( $\$2\text{ million} + \$84,600 - \$200,000$ ), and the carrying amount of the underlying asset is \$1,714,286 ( $\$1.8\text{ million} - \$85,714$ ). The carrying amount of Buyer's financial asset is \$1,880,000 ( $\$2\text{ million} + \$80,000 - \$200,000$ ).

**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 ( $\$1,350,041 \div 16\text{ years remaining useful life}$ ).

**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.

9.3.10 A failed sale-leaseback transaction occurs when the transaction does not meet the requirements for sale/purchase recognition (see section 9.1). Instead, the transaction is accounted for as a financing transaction by both the seller-lessee and buyer-lessor. [842-40-25-5, 55-34]

- The seller-lessee recognizes proceeds received from the buyer-lessor as a financial liability (financing method) and does not derecognize the transferred asset. The seller-lessee continues to depreciate the transferred asset.
- The buyer-lessor does not recognize the transferred asset and accounts for proceeds paid to the seller-lessee as a receivable (financial asset).



### Question 9.3.10

#### **Useful life of the underlying asset in a failed sale-leaseback transaction**

#### **What is the remaining useful life of the underlying asset in a failed sale-leaseback?**

**Background:** In a failed sale-leaseback, the seller-lessee continues to recognize and depreciate the underlying asset (see paragraph 9.3.10). However, the question arises about what the remaining useful life is for the underlying asset after the failed sale.

**Interpretive response:** It depends. When a failed sale occurs, the underlying asset remains, for accounting purposes, owned PP&E of the seller-lessee and no lease exists yet. Therefore, the useful life guidance in Topic 360 applies, and the same general considerations that apply to the seller-lessee's legally owned PP&E apply to the underlying asset.

Considering that guidance, the failed sale-leaseback transaction may trigger a change to the underlying asset's useful life – i.e. the period over which the asset is expected to contribute directly or indirectly to future cash flows. [ASC Master Glossary]

The following are examples.

- A seller-lessee may conclude that the asset will no longer contribute to its future cash flows after it will be sold. Assume a leaseback term of 10 years, but a successful sale will occur at the end of Year 7 when the repurchase option causing the failed sale expires. While the seller-lessee will continue to use the underlying asset after the end of Year 7, it will control an ROU asset instead of the underlying asset from that date. We believe it would be reasonable to conclude the useful life of the underlying asset to the seller-lessee is only seven years.

- If a successful sale will not occur until the lease ends, we believe it is reasonable to consider the expected duration of the lease when determining the remaining useful life of the asset. Assume a maximum possible leaseback term of 15 years (a 10-year noncancelable period plus five one-year renewal options). The seller-lessee in this scenario may assign a remaining useful life equal to the expected duration of the lease (i.e. when it expects the sale to occur), even if that differs from either the maximum possible leaseback term or the Topic 842 ‘lease term’.
- The availability of the sale proceeds for repairs of, or upgrades to, the underlying asset or for acquiring other assets could affect the seller-lessee’s plans with respect to use of the asset as compared to its plans pre-transaction. This may result in the useful life being shortened or lengthened.

The above notwithstanding, Example 2 in Subtopic 842-40 illustrates a failed sale-leaseback transaction. The seller-lessee’s post FAILED sale useful life in the example exceeds all of the following: [842-40-55-31, 55-34]

- the maximum possible leaseback term;
- the leaseback term that would apply to a successful sale-leaseback transaction; and
- if shorter, the period of time until the buyer-lessor will obtain control of the underlying asset (see paragraph 9.3.50) – e.g. if a seller-lessee repurchase option that precludes sale accounting expires before the end of the leaseback term.

Based on Example 2, we do not believe the remaining useful life of the underlying asset must be capped at any of the above.

However, if the underlying asset is a property improvement (building or integral equipment) constructed or installed on land leased from the lessor, the useful life of the property improvements cannot exceed the lease term for the land lease. As examples, this can arise (not exhaustive): [842-20-35-12]

- in a build-to-suit scenario (see section 9.4) where the lessor legally owns the land and the building, but the lessee is deemed to own the building for accounting purposes and fails sale accounting at the end of the construction period; or
- when land and a building are sold and leased back together, but only the land is successfully sold (see Question 9.1.110).

### **Salvage value**

In addition to determining an appropriate remaining useful life of the underlying asset, the seller-lessee needs to consider the asset’s salvage value at the end of that useful life. We believe the salvage value of the asset should usually equal the lesser of (1) its expected residual value and (2) the carrying amount of the financial liability the asset’s transfer will extinguish.

This is because, while it is the asset itself that is recognized instead of an ROU asset, it is the buyer-lessor (not the seller-lessee) that is entitled to any residual asset value in excess of the financial liability balance. For example, the seller-lessee cannot realize any additional salvage value by selling the asset to a third

party because it is legally owned by the buyer-lessor. For this reason, if there is no financial liability, or its carrying amount will be zero at the sale date, the asset's salvage value should generally also be \$0.

We believe this approach has the practical effect of eliminating any remaining built-in loss unresolved by making the interest rate adjustment in paragraph 9.3.30.

9.3.20 When a seller-lessee determines that control of the underlying asset has not transferred to the buyer-lessor (i.e. there is a failed sale), the agreed-upon sales price may indicate that the carrying amount of the asset is not recoverable if the sales price is lower than the carrying amount. However, an off-market sales price that is below the fair value of the asset and less than its carrying amount does not automatically mean that the carrying amount of the underlying asset is not recoverable. [360-10-35-21]

9.3.30 In applying the financing method, the seller-lessee adjusts the interest rate on its financial liability to ensure that: [842-40-30-6]

- interest on the financial liability is not greater than the payments made on the financial liability – i.e. there is not negative accretion on the liability – over the shorter of the lease term or the term of the financing; and
- the carrying amount of the underlying asset will not exceed the financing obligation at the earlier of (1) the end of the lease term, and (2) when control of the underlying asset transfers to the buyer-lessor (see paragraph 9.3.50) – i.e. the seller-lessee adjusts the interest rate to ensure there is not a built-in loss.



### Question 9.3.20 Negative accretion assessed in the aggregate

**Is the interest rate required to be adjusted if there will be negative accretion of the financing liability in one or some periods, but positive accretion over the entirety of the shorter of the lease term or the financing term?**

**Interpretive response:** No. Negative accretion could occur in only one or some of the periods during the shorter of the lease term or the term of the financing because, for example, there is a free-rent holiday at the beginning of, or at some point during, the lease term or because the lease payments escalate during the lease term.

When evaluating whether an interest rate adjustment is required in accordance with paragraph 9.3.30, the analysis is an aggregate one. It only considers whether there will be negative accretion over the entirety of the 'shorter of' period. If the interest rate will only result in negative accretion during one or some periods within that period, the interest rate is not adjusted.



### Question 9.3.25

#### Adjusting the interest rate on a failed sale-leaseback transaction during the financing period

### Should the seller-lessee in a failed sale-leaseback transaction lower the interest rate on its financial liability if the underlying asset is impaired or its useful life is shortened?

**Background:** As outlined in paragraph 9.3.30, the interest rate on the seller-lessee's failed sale-leaseback financial liability is adjusted upward if necessary to ensure the carrying amount of the underlying asset will not exceed the financial liability at the earlier of (1) the end of the lease term, and (2) when control of the underlying asset transfers to the buyer-lessor ('earlier of date').

The 'failed sale period' is the period between the contractual sale date and when a sale occurs for accounting purposes under Subtopic 842-40. During that period, the seller-lessee continues to recognize and depreciate the underlying asset (see paragraph 9.3.10 and Question 9.3.10), and to recognize any impairment losses under Topic 360. As a result of following these requirements, the carrying amount may be adjusted in a way that was not contemplated when the interest rate was determined. This could occur, for example, if the underlying asset is impaired under Topic 360 during the period or if the useful life of the asset is reduced (see Question 9.3.10).

**Interpretive response:** No. While Topic 842 does not explicitly discuss subsequent adjustments to the interest rate, we believe the subsequent accounting for the underlying asset and the financial liability are independent. This means that the interest rate on the financial liability should not be adjusted during the failed sale period as a result of changes in the seller-lessee's accounting for the underlying asset, such as recognition of an impairment loss or a change in the asset's useful life.

9.3.40 Example 2 in Subtopic 842-40 demonstrates the accounting for a failed sale-leaseback transaction. [842-40-55-31 – 55-38]

9.3.50 A failed sale-leaseback transaction may qualify for sale/purchase accounting at some point during the term of the leaseback. For example: [842-40-55-31 – 55-38, ASU 2016-02.BC369]

- the buyer-lessor may obtain control of the asset (and therefore complete the sale/purchase) before the end of the leaseback term if a seller-lessee repurchase option (or other specific feature) that precluded sale/purchase accounting expires; or
- the control guidance in Topic 606 may suggest that the buyer-lessor has not obtained control of the asset at the leaseback commencement date, but may suggest otherwise before the end of the leaseback term.

9.3.60 If an initially failed sale-leaseback transaction qualifies for sale/purchase accounting before the end of the leaseback term: [842-40-55-31 – 55-38]

- the seller-lessee derecognizes the remaining financial liability and the carrying amount of the asset, and recognizes a gain for the difference; and

- the buyer-lessor derecognizes its remaining financial asset and recognizes the transferred asset at that same amount.

9.3.70 Both parties then account for the remaining leaseback in accordance with the applicable lessee and lessor guidance from the date the sale/purchase is deemed to occur for accounting purposes. However, they both use the discount rate for the lease that would have been established at the contractual lease commencement date. This only matters for the buyer-lessor if the leaseback is a direct financing lease because a buyer-lessor cannot have a sales-type leaseback and does not recognize lease assets to be discounted for an operating leaseback. [842-40-55-31 – 55-38]

9.3.80 Example 2 in Subtopic 842-40 states that the seller-lessee uses the lease commencement date discount rate because that rate more closely reflects the interest rate that would have been considered by the buyer-lessor in pricing the lease. [842-40-55-31 – 55-38]



### Question 9.3.30

#### **Reassessing lease classification in a failed sale-leaseback**

#### **When should classification of a leaseback be reassessed in a failed sale-leaseback transaction?**

*The FASB has received a request to add a project to its technical agenda that is relevant to this Question. Consequently, there may be further developments around this issue, in which case we will update this interpretive response in a future edition.*

**Interpretive response:** In general, we believe leaseback classification should not be reassessed in a failed sale-leaseback transaction unless a lease classification reassessment event occurs after the contractual leaseback commencement date.

Those events are: [842-10-25-1]

- a modification of the lease that is not accounted for as a separate contract (*all entities*);
- a change in the lease term (*seller-lessee only*); or
- a change in the assessment of a lessee option to repurchase the underlying asset (*seller-lessee only*).

Those events do *not* include when one or more condition(s) previously precluding sale/purchase accounting is (are) cured (e.g. expiration of a seller-lessee repurchase option), even if the curing of that (those) condition(s) results in the transaction now qualifying for sale/purchase accounting.

When a sale-leaseback transaction qualifies for sale/purchase accounting during the contractual leaseback term (see paragraph 9.3.50), the incremental borrowing rate used by the seller-lessee to discount the lease liability when the sale and leaseback are recognized is the incremental borrowing rate as of the *contractual* commencement date. This is because that rate more closely

reflects the interest rate that would have been considered by the buyer-lessor in pricing the lease. [842-40-55-36]

Following that logic, it would be inconsistent to classify the lease as of the date the sale/purchase is recognized because changes in circumstances since the contractual commencement date (e.g. changes to the fair value of the underlying asset) may similarly be unrelated to the economics of the negotiated transaction. Those changes in circumstances could result in a conclusion that a leaseback that was negotiated and structured by the parties to be an operating lease would be classified as a finance/sales-type lease at this later date, which would then continue to preclude sale and leaseback accounting even though the condition(s) that initially precluded the sale/purchase has (have) been cured. We believe this to be inconsistent with the FASB's intent.

### **Failed sale/purchase resulting from finance/sales-type classification**

Absent a lease classification reassessment event, a failed sale/purchase resulting *solely or partially* from finance/sales-type leaseback classification should be accounted for by the parties as a financing until the leaseback expires. We do not believe it was the FASB's intent for transactions that result in a failed sale/purchase at contractual commencement based on lease classification to potentially achieve sale/purchase accounting later solely from the passage of time.

Consider the following examples.

- At the contractual leaseback commencement date, an 8-year leaseback of an asset with a 10-year remaining economic life would fail the 'lease term test'. However, at the end of Year 3 of the leaseback, the 5-year remaining leaseback term would no longer equal a major part of the 7-year remaining economic life of the underlying asset.
- If the leaseback is classified as a finance/sales-type lease at the contractual commencement date because of failing the 'present value test', a subsequent increase in the fair value of the underlying asset after that date (which could later reverse itself) might result in a different conclusion if the test were re-performed.
- An alternative use for the transferred asset to the buyer-lessor may arise after the contractual commencement date.

In each of these examples, if the parties reassess classification of the leaseback – either continuously or when all other failure conditions, such as a repurchase option, have been cured – a sale and leaseback could result; for example, at the end of Year 3 in the first example. In contrast, if the parties do *not* do so, and no lease classification reassessment event occurs (see paragraph 6.2.40), all of these transactions will remain failed sales/purchases, accounted for as financing transactions, until the contractual leaseback expires. [842-10-25-1]

We believe it was the FASB's intent to revisit the accounting for the transaction only if a change occurs that affects the economics of the lease from those contemplated in negotiating and pricing the lease.

### Alternative approach

As an alternative, we believe Example 2 in Subtopic 842-40 (accounting for a failed sale and leaseback transaction) could support reassessing leaseback classification when the condition(s) previously precluding a sale/purchase is (are) cured if, and only if, leaseback classification – at the later of the contractual commencement date and the most recent classification reassessment event – would not have also precluded sale/purchase accounting.

This view is based on the following. [842-10-25-1, 842-40-55-36]

- Lease classification is assessed at lease commencement under Topic 842.
- A sentence in Example 2 states that the date of sale (i.e. the date the repurchase option that precluded a successful sale/purchase expires) is the ‘commencement date of the leaseback for accounting purposes’.

While we believe the above sentence in Example 2 was intended to refer solely to the date the accounting should commence (i.e. when the leaseback liability and ROU asset are recognized) – and not to suggest that lease classification should be assessed (or reassessed) at that date – we acknowledge that this is unclear. We therefore would accept this alternative approach as an accounting policy election.

We do not believe Example 2 supports requiring or permitting leaseback classification reassessment when the failed sale/purchase results solely or partially from finance/sales-type classification. This is because that example states explicitly that the seller-lessee repurchase option is the only factor that precludes a successful sale/purchase at the asset transfer date – i.e. sale/purchase accounting was not also precluded because of lease classification. Therefore, any transaction where lease classification is an additional reason for the failed sale/purchase differs from Example 2. [842-40-55-32]


**Question 9.3.40**  
**Buyer-lessor accounting for initial direct costs incurred in a failed sale-leaseback transaction**

### What guidance should a buyer-lessor apply to determine the initial direct costs in a failed sale-leaseback transaction?

**Background:** In a failed sale-leaseback transaction, the seller-lessee does not derecognize the underlying asset and reflects the proceeds from the transaction as a financial liability (i.e. borrowing). Conversely, the buyer-lessor does not recognize the transferred asset and reflects the cash payment as a loan to the seller-lessee (i.e. lending activity).

Topic 842 provides guidance on the accounting for initial direct costs from a lease transaction, while Subtopic 310-20 (receivables – nonrefundable fees and other costs) provides guidance on capitalizing loan origination costs. Therefore, the question arises as to which guidance governs origination costs in a failed sale-leaseback transaction.

**Interpretive response:** Topic 842 is not clear as to whether those costs should be accounted for under the leasing or financial instruments guidance.

We believe that because a failed sale-leaseback transaction initially falls within the scope of Topic 842 and then subsequently is accounted for as a loan, either of the above alternatives are acceptable if applied consistently by the buyer-lessor. The guidance in Subtopic 310-20 may result in capitalizing more initial direct costs than those capitalized under Topic 842 because the capitalizable costs under that Subtopic include items that do not meet the definition of initial direct costs under Topic 842.

If a buyer-lessor capitalizes origination costs in accordance with Subtopic 310-20, at the point a successful sale-leaseback occurs, there may be unamortized capitalized costs that do not meet the definition of initial direct costs in Topic 842. In that circumstance, neither Topic 842 nor other GAAP directly addresses how the buyer-lessor should account for those costs. Consequently, we believe the following would be acceptable.

#### The leaseback is classified as a direct financing lease

If the leaseback is classified as a direct financing lease, either of the following approaches is acceptable.

- **Expense.** Write off the unamortized origination costs that do not meet the definition of initial direct costs under Topic 842 as an expense at the successful sale date. Under this approach, the buyer-lessor recognizes the net investment in the lease at an amount equal to its financing receivable immediately before the sale's successful completion less the unamortized origination costs written off. This results in a net investment in the lease that is generally determined in the same manner as it would be for a sale-leaseback transaction that is accounted for as a sale initially. The buyer-lessor also recomputes the rate implicit in the lease under this approach so that the remaining leaseback payments plus the original estimated residual value equal the new balance of the net investment in the lease.
- **Capitalize.** Measure the net investment in the lease at the carrying amount of the financing receivable (inclusive of all of the unamortized origination costs). This approach is consistent with Example 2 in Subtopic 842-40, in which the underlying asset is recognized by the buyer-lessor at the successful sale date at the carrying amount of the financing receivable, and with the notion that the buyer-lessor is simply recharacterizing the financing receivable as a net investment in a lease. [842-40-55-36]

#### The leaseback is classified as an operating lease

If the leaseback is classified as an operating lease, either of the following approaches is acceptable.

- **Expense.** Write off the unamortized costs included in the financing receivable that do not meet the definition of initial direct costs under Topic 842 as an expense at the successful sale date, and reclassify the remaining unamortized costs as deferred initial direct costs to be recognized as an expense over the remaining lease term in the same pattern as lease income. Under this approach, the buyer-lessor recognizes the underlying asset at an amount equal to its financing receivable immediately before the sale's successful completion less the unamortized

origination costs. This results in an amount capitalized as property, plant and equipment that is determined in the same manner as it would be for a sale-leaseback transaction that is accounted for as a sale initially.

- **Capitalize.** Measure the newly recognized underlying asset at the carrying amount of the financing receivable (inclusive of all of the unamortized origination costs). This approach is consistent with Example 2 in Subtopic 842-40, in which the underlying asset is recognized by the buyer-lessor at the successful sale date at the carrying amount of the financing receivable, and with the notion that the buyer-lessor is simply recharacterizing the financing receivable as property, plant and equipment. [842-40-55-36]



### Example 9.3.10

#### **Failed sale-leaseback transaction – repurchase option not reasonably certain to be exercised (seller-lessee accounting)**

Seller-Lessee SL enters into a contract (that meets the contract existence criteria in Topic 606) with Buyer-Lessor BL for the sale-leaseback of equipment.

SL has an option to repurchase the equipment at the end of the noncancelable leaseback term at a fixed price of \$5 million (intended to approximate the fair value of the equipment at that date). Because of this option, which does not meet the criteria in paragraph 9.1.50, control of the equipment does not transfer to BL until after the repurchase option expires. Therefore, SL accounts for the transaction as a failed sale (see section 9.1).

In each of the scenarios below, the repurchase option is not reasonably certain to be exercised, which is relevant to determining the lease payments used to adjust the interest rate.

The following additional facts are relevant.

Equipment remaining economic life:	12 years
Equipment remaining useful life:	5 years
Net carrying amount of equipment on contractual date of sale:	\$10 million
Expected residual value at end of Year 5:	\$5 million
Annual depreciation:	\$1 million
Sales price:	\$12 million
Leaseback term:	5 years
Leaseback renewal options:	One 5-year renewal option
Contractual lease payment:	Fixed payments of \$1.2 million per year (in arrears)
Interest rate (determined in accordance with paragraphs 835-30-25-12 – 25-13):	5.80%

### Scenario 1: No adjustment to interest rate required

Using the interest rate of 5.80%, SL calculates the amortization table for the financial liability as follows.

Period	Asset carrying amount	Financial liability balance	Contractual lease payment	Principal portion of payment	Interest expense
Commencement	\$10,000,000	\$12,000,000	\$ -	\$ -	\$ -
Year 1	9,000,000	11,496,000 <sup>1</sup>	1,200,000	504,000 <sup>2</sup>	696,000 <sup>3</sup>
Year 2	8,000,000	10,962,768	1,200,000	533,232	666,768
Year 3	7,000,000	10,398,609	1,200,000	564,159	635,841
Year 4	6,000,000	9,801,728	1,200,000	596,881	603,119
Year 5	5,000,000	9,170,228	1,200,000	631,500	568,500

Next, SL applies the tests in paragraph 9.3.30 and confirms that the interest rate does not require adjustment:

- over the five-year term, the interest on the financial liability (\$3,170,228) does not exceed the contractual lease payments (\$6,000,000); and
- at the end of Year 5, the expected carrying amount of the underlying asset (\$5,000,000)<sup>4</sup> does not exceed the carrying amount of the financial liability (\$9,170,228).

When the sale occurs for accounting purposes at the end of Year 5, because the repurchase option expires, SL recognizes a gain of \$4,170,228 (\$9,170,228 – \$5,000,000).

Notes:

1. Financial liability of \$11,496,000 is calculated as the financial liability at the beginning of the period reduced by the principal portion of the Year 1 payment (\$12,000,000 – \$504,000).
2. Reduction to principal of \$504,000 is calculated as the contractual lease payment less interest expense (\$1,200,000 – \$696,000).
3. Interest expense of \$696,000 is calculated as the financial liability at the beginning of the period multiplied by the interest rate (\$12,000,000 × 5.80%).
4. Carrying amount at the start of Year 1 (\$10,000,000) less \$1,000,000 depreciation per year for five years.

### Scenario 2: Interest rate adjusted to avoid negative accretion

Assume the same facts as Scenario 1, except that the lease payments are fixed at \$650,000 per year (paid in arrears).

Using the interest rate of 5.80%, SL calculates the amortization table for the financial liability as follows.

Period	PP&E net carrying amount	Financial liability balance	Contractual lease payment	Reduction/(Increase) to principal	Interest expense
Commencement	\$10,000,000	\$12,000,000	\$ -	\$ -	\$ -
Year 1	9,000,000	12,046,000	650,000	(46,000)	696,000

Period	PP&E net carrying amount	Financial liability balance	Contractual lease payment	Reduction/(Increase) to principal	Interest expense
Year 2	8,000,000	12,094,668	650,000	(48,668)	698,668
Year 3	7,000,000	12,146,159	650,000	(51,491)	701,491
Year 4	6,000,000	12,200,636	650,000	(54,477)	704,477
Year 5	5,000,000	12,258,273	650,000	(57,637)	707,637

Next, SL applies the tests in paragraph 9.3.30 and determines that the interest rate requires adjustment:

- at the end of the five years, the expected carrying amount of the underlying asset (\$5,000,000) does not exceed the carrying amount of the financial liability (\$12,258,273); but
- over the five-year term, the interest on the financial liability (\$3,508,273) exceeds the contractual lease payments (\$3,250,000).

To avoid negative accretion on the financial liability over the five-year term, SL makes interest expense equal the contractual lease payments, which requires an adjusted interest rate of 5.42% (rounded).

Period	PP&E net carrying amount	Financial liability balance	Contractual lease payment	Reduction/(Increase) to principal	Interest expense
Commencement	\$10,000,000	\$12,000,000	\$ -	\$ -	\$ -
Year 1	9,000,000	12,000,000	650,000	-	650,000
Year 2	8,000,000	12,000,000	650,000	-	650,000
Year 3	7,000,000	12,000,000	650,000	-	650,000
Year 4	6,000,000	12,000,000	650,000	-	650,000
Year 5	5,000,000	12,000,000	650,000	-	650,000

When the sale occurs for accounting purposes at the end of Year 5, because the repurchase option expires, SL recognizes a gain of \$7,000,000 (\$12,000,000 – \$5,000,000).

### Scenario 3: Interest rate adjusted to avoid built-in loss on sale

Assume the same facts as Scenario 1, except that the lease payments are fixed at \$2,000,000 per year (paid in arrears).

Using the interest rate of 5.80%, SL calculates the amortization table for the financial liability as follows.

Period	PP&E net carrying amount	Financial liability balance	Contractual lease payment	Principal portion of payment	Interest expense
Commencement	\$10,000,000	\$12,000,000	\$ -	\$ -	\$ -
Year 1	9,000,000	10,696,000	2,000,000	1,304,000	696,000

Period	PP&E net carrying amount	Financial liability balance	Contractual lease payment	Principal portion of payment	Interest expense
Year 2	8,000,000	9,316,368	2,000,000	1,379,632	620,368
Year 3	7,000,000	7,856,717	2,000,000	1,459,651	540,349
Year 4	6,000,000	6,312,407	2,000,000	1,544,310	455,690
Year 5	5,000,000	4,678,527	2,000,000	1,633,880	366,120

Next, SL applies the tests in paragraph 9.3.30 and identifies that the interest rate requires adjustment:

- over the five-year term, the interest on the financial liability (\$2,678,527) does not exceed the contractual lease payments (\$10,000,000); but
- at the end of the five years, the expected carrying amount of the underlying asset (\$5,000,000) exceeds the carrying amount of the financial liability (\$4,678,527).

To avoid a loss when the sale is recorded, SL adjusts the interest expense to ensure that the carrying amount of the financial liability at the end of the five years is \$5,000,000, which requires an adjusted interest rate of 6.40% (rounded).

Period	PP&E net carrying amount	Financial liability balance	Contractual lease payment	Principal portion of payment	Interest expense
Commencement	\$10,000,000	\$12,000,000	\$ -	\$ -	\$ -
Year 1	9,000,000	10,768,128	2,000,000	1,231,872	768,128
Year 2	8,000,000	9,457,403	2,000,000	1,310,725	689,275
Year 3	7,000,000	8,062,778	2,000,000	1,394,625	605,375
Year 4	6,000,000	6,578,882	2,000,000	1,483,896	516,104
Year 5	5,000,000	5,000,000	2,000,000	1,578,882	421,118

When the repurchase option expires, the carrying amount of the equipment and the balance of the financial liability are the same, and therefore SL recognizes no gain or loss at the time of sale.



### Example 9.3.20#

#### Failed sale-leaseback transaction – repurchase option reasonably certain to be exercised (seller-lessee accounting)

Assume the same facts as Example 9.3.10 Scenario 1, except that the strike price of the repurchase option is \$8 million, and the option is reasonably certain to be exercised at the end of the leaseback term (see section 5.2).

It is reasonably certain that control of the underlying equipment will never transfer to Buyer-Lessor BL and that Seller-Lessee SL will make an \$8 million payment to BL at the end of the leaseback term. Therefore, an interest rate of 3.82% (rounded) is imputed so that:

- the financial liability at the end of the leaseback term will equal the repurchase option price; and
- no gain or loss is recognized upon payment of the repurchase option exercise price.

While paragraph 842-40-30-6 does not appear to contemplate scenarios in which the underlying asset will never transfer to the buyer-lessor, SL observes that the 3.82% interest rate:

- does not result in aggregate interest on the financial liability that exceeds the cumulative principal payments on that liability over the contractual leaseback term; and
- does not give rise to either (1) an equipment carrying amount that exceeds the financial liability at the end of the contractual leaseback term, or (2) any 'built-in loss'.

With respect to (2), a built-in loss cannot arise from transferring control of the equipment to BL because such transfer will not occur, and similarly should not occur if the financial liability is accreted so that it appropriately equals the exercise price of the repurchase option SL is reasonably certain to exercise at the end of the contractual leaseback term.

Period	PP&E net carrying amount	Financial liability balance	Contractual lease payment	Principal portion of payment	Interest expense
Commencement	\$10,000,000	\$12,000,000	\$ -	\$ -	\$ -
Year 1	9,000,000	11,258,891	1,200,000	741,109	458,891 <sup>1</sup>
Year 2	8,000,000	10,489,441	1,200,000	769,450	430,550
Year 3	7,000,000	9,690,567	1,200,000	798,874	401,126
Year 4	6,000,000	8,861,143	1,200,000	829,424	370,576
Year 5	5,000,000	-	9,200,000 <sup>2</sup>	8,861,143	338,857

Notes:

1. Interest expense is calculated by multiplying the balance of the financial liability by the adjusted interest rate ( $\$12,000,000 \times 3.82\%$  [rounded]).
2. Lease payment for Year 5 is calculated as the fixed annual lease payment plus repurchase option strike price ( $\$1,200,000 + \$8,000,000$ ).
3. Over the five-year term, the aggregate interest on the financial liability ( $\$2,000,000$ ) does not exceed the contractual lease payments, whether inclusive or exclusive of the repurchase option payment ( $\$6,000,000$  or  $\$14,000,000$ ).



### Example 9.3.30

#### Failed sale-leaseback transaction (buyer-lessor accounting)

Assume the same facts as Example 9.3.10, Scenario 1. Buyer-Lessor BL concludes that the contract is a failed sale-leaseback because the contract offers Seller-Lessee SL a fixed price repurchase option (see section 9.1). In this example, this is the only provision of the arrangement preventing the transaction from qualifying for sale-leaseback accounting. This is the same conclusion independently reached by SL in Example 9.3.10.

BL accounts for the transaction as follows.

- BL recognizes the payment of \$12 million to SL as a financial asset and does not recognize the underlying asset.
- Under paragraphs 835-30-25-12 – 25-13, BL determines an appropriate interest rate to be 6%. This is based on prevailing rates for similar instruments, BL's assessment of the creditworthiness of SL, and other factors assumed in pricing the contractual leaseback.

BL calculates the amortization table for the financial asset as follows.

Period	Contractual lease payment	Interest income	Financial asset ending balance
Commencement	\$ -	\$ -	\$12,000,000
Year 1	1,200,000	720,000 <sup>1</sup>	11,520,000
Year 2	1,200,000	691,200	11,011,200
Year 3	1,200,000	660,672	10,471,872
Year 4	1,200,000	628,312	9,900,184
Year 5	1,200,000	594,011	9,294,195

Note:

1. Interest income is calculated by multiplying the balance of the financial asset by the imputed interest rate ( $\$12,000,000 \times 6\%$ ).

Control of the asset transfers to BL when the repurchase option expires at the end of Year 5, which in this case is at the end of the contractual leaseback term. BL recognizes the purchase of the asset by derecognizing the carrying amount of its financial asset (\$9,294,195) and recognizing the transferred asset at the same amount. BL depreciates the asset from this date forward based on Topic 360.

**Note:** If control of the asset transferred before the end of the contractual leaseback, BL would derecognize the financial asset and recognize the transferred asset in the same amount as the financial asset, begin depreciation, and begin accounting for the lease based on the lease classification determined at the contractual commencement date (see Question 9.3.30).



## Comparison to legacy US GAAP

### **Seller-lessee accounting for failed sale-leaseback transactions is generally consistent with practice under Topic 840**

9.3.90 Consistent with Topic 842, a failed sale-leaseback transaction under Topic 840 was generally accounted for as a financing transaction. However, unlike Topic 842, Topic 840 also permitted use of the deposit method when the sales price of the underlying asset was paid to the seller-lessee over time. Therefore, the *requirement* to use the financing method in all failed sales represents a change from the legacy guidance in Topic 840. [840-40-25-11]

### **Adjusting the discount rate for failed sale-leaseback transactions**

9.3.100 While practice under Topic 840 developed in a manner similar to the guidance on adjusting the discount rate in a failed sale-leaseback transaction under Topic 842 (see paragraph 9.3.30), Topic 840 did not have explicit guidance of this nature.

### **New 'failed purchase' accounting**

9.3.110 When the transfer of the asset does not qualify for sale/purchase accounting based on the relevant guidance in Topic 606, Topic 842 requires the buyer-lessor to account for the sale-leaseback transaction as a 'failed purchase'. In contrast, Topic 840 did not require the buyer-lessor to account for a failed purchase, even if the seller-lessee accounted for the transaction as a failed sale.

## 9.4

## Lessee control before lease commencement



### Excerpt from ASC 842-40

#### **55 Implementation Guidance and Illustrations**

##### **General**

- > Implementation Guidance
- > Control of the Underlying Asset before the Commencement Date

**55-1** A lessee may obtain legal title to the **underlying asset** before that legal title is transferred to the **lessor** and the asset is leased to the lessee. If the lessee controls the underlying asset (that is, it can direct its use and obtain substantially all of its remaining benefits) before the asset is transferred to the lessor, the transaction is a sale and leaseback transaction that is accounted for in accordance with this Subtopic.

**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.

- > Costs of the Lessee Relating to the Construction or Design of an Underlying Asset

**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).

**55-5** If the lessee controls the underlying asset being constructed before the commencement date, the transaction is accounted for in accordance with this Subtopic. Any one (or more) of the following would demonstrate that the lessee controls an underlying asset that is under construction before the commencement date:

- a. The lessee has the right to obtain the partially constructed underlying asset at any point during the construction period (for example, by making a payment to the lessor).
- b. The lessor has an enforceable right to payment for its performance to date, and the asset does not have an alternative use (see paragraph 842-10-55-7) to the owner-lessor. In evaluating whether the asset has an alternative use to the owner-lessor, an entity should consider the characteristics of the asset that will ultimately be leased.
- c. The lessee legally owns either:
  1. Both the land and the property improvements (for example, a building) that are under construction
  2. The non-real-estate asset (for example, a ship or an airplane) that is under construction.
- d. The lessee controls the land that property improvements will be constructed upon (this includes where the lessee enters into a transaction to transfer the land to the lessor, but the transfer does not qualify as a sale in accordance with paragraphs 842-40-25-1 through 25-3) and does not enter into a lease of the land before the beginning of construction that, together with renewal options, permits the lessor or another unrelated third party to lease the land for substantially all of the economic life of the

property improvements.

- e. The lessee is leasing the land that property improvements will be constructed upon, the term of which, together with lessee renewal options, is for substantially all of the economic life of the property improvements, and does not enter into a sublease of the land before the beginning of construction that, together with renewal options, permits the lessor or another unrelated third party to sublease the land for substantially all of the economic life of the property improvements.

The list of circumstances above in which a lessee controls an underlying asset that is under construction before the commencement date is not all inclusive. There may be other circumstances that individually or in combination demonstrate that a lessee controls an underlying asset that is under construction before the commencement date.

**55-6** See Example 3 (paragraphs 842-40-55-39 through 55-44) for an illustration of the scope of this Subtopic.

- > Lessee Indemnification for Environmental Contamination

**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.

> Illustrations

- > Illustration of Guidance on Application of Costs of the Lessee Relating to the Construction or Design of an Underlying Asset

**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 construction in process from Lessor). In addition, while the building is being developed to Lessee's specifications, those specifications are not so specialized that the asset does not have an alternative use to Lessor.

- • • > Case A—Lessee Does Not Control the Asset under Construction

**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).

9.4.10 If the lessee controls the underlying asset before the lease commencement date, the transaction is in the scope of the sale-leaseback guidance and the accounting described in sections 9.2 and 9.3 applies. However, obtaining legal title alone, especially if title is obtained only momentarily (flash title), does not necessarily mean that the lessee controls the underlying asset before the commencement date. [842-40-55-1 – 55-2, 55-5]



### Question 9.4.05

#### **Control of an underlying asset pre-lease commencement when multiple parties are involved**

### **How does an entity determine if it obtains control of an underlying asset before lease commencement when multiple parties are involved?**

**Background:** *This question does not address underlying assets under construction (see section 9.4.1).*

Some lease arrangements involve multiple parties; for example:

- a supplier (original equipment manufacturer, or OEM) that manufactured the underlying asset and delivers it for lease;
- the entity that will lease the manufactured underlying asset; and
- a financier (e.g. a bank) that will purchase the underlying asset with the express intent of leasing it to the entity.

Depending on the facts and circumstances, the entity that will lease the underlying asset may obtain ‘control’ (see paragraph 9.1.30) of it before control transfers to the financier. In that case, the sale-leaseback guidance applies, with the entity as seller-lessee and the financier as buyer-lessor.

Alternatively, despite the entity’s involvement in the arrangement before commencement of its lease with the financier, the entity may *not* obtain control of the underlying asset before it is transferred to (and control obtained by) the financier. In that case, the sale-leaseback guidance does *not* apply to the lease between financier (as lessor) and the entity (as lessee).

The effect of this determination can be significant. For example, if the lease between financier and the entity includes a fixed price purchase option for the underlying asset, the transaction will fail sale-leaseback accounting (see paragraph 9.1.50); section 9.3 discusses the accounting for a failed sale-leaseback. By contrast, that same fixed price purchase option – whether reasonably certain of exercise or not (see section 5.2) – does not affect that both parties will apply lease accounting to the transaction when it is *not* a sale-leaseback.

**Interpretive response:** While Topic 842 provides explicit guidance on determining whether a lessee controls an underlying asset under construction, it does not provide explicit guidance to determine whether a lessee obtains control of an underlying asset in a multi-party transaction such as that described in the background.

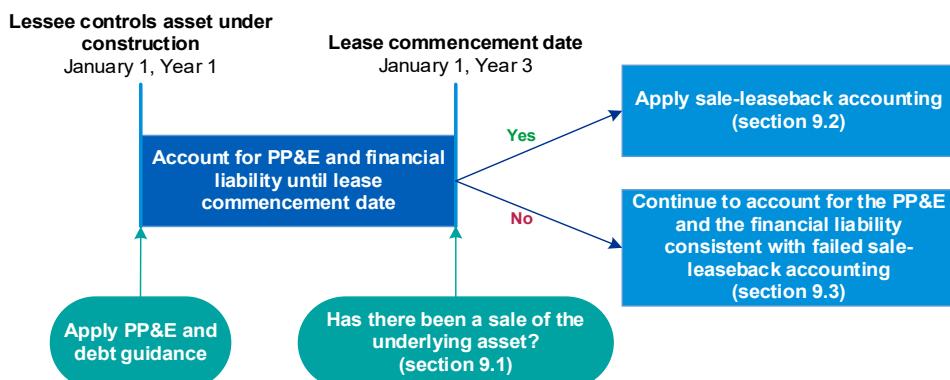
In this type of transaction, we believe the principal versus agent guidance in Topic 606 (revenue from contracts with customers) provides an appropriate framework.

- If the lessee is the principal to the sale (transfer) of the underlying asset to the ultimate lessor (i.e. rather than another party, such as the supplier in the background example), that means the lessee controlled the underlying asset before its sale (transfer) and the transaction is a sale-leaseback.

- If the lessee is *not* the principal to that sale (transfer), that means it did not control the underlying asset beforehand.

Applying the principal-agent guidance in Topic 606 frequently involves judgment and careful consideration of all relevant facts and circumstances. Chapter 9 of KPMG Handbook, [Revenue recognition](#), provides interpretive guidance; Questions 9.3.40, 9.3.50 and 9.3.55 may be particularly relevant to scenarios like those described in this question.

- 9.4.20 The following diagram explains how the sale-leaseback guidance interacts with the accounting for lessees (see chapter 6) and lessors (see chapter 7) when the lessee controls the underlying asset before the commencement date.



- 9.4.30 The guidance in Subtopic 842-40 stipulates that having legal title to an asset, especially if that legal title is only obtained momentarily (often referred to as 'flash title') before it is transferred to another entity, does not mean a lessee controls the underlying asset before lease commencement. This is consistent with the guidance in Topic 606, which treats legal title only as an indicator of control and also provides specific guidance that obtaining flash title to a good does not mean an entity controls that good. [\[606-10-55-37\]](#)

## 9.4.1 Lessee involvement in the construction or design of the underlying asset

- 9.4.40 A lessee may enter into a lease in which the underlying asset needs to be constructed or redesigned for use by the lessee, sometimes referred to as a build-to-suit lease. Depending on the terms and conditions of the contract, the lessee may be required to make payments related to the construction or design of the asset. [\[842-40-55-3\]](#)

- 9.4.50 If a lessee incurs costs relating to the construction or design of an underlying asset before the commencement date, it applies other US GAAP (e.g. Topic 330 on inventory or Topic 360 on property, plant and equipment) to account for such costs. However, costs relating to the construction or design of the underlying asset do not include payments made for the right to use the underlying asset (i.e. lease payments), regardless of the timing of those payments or the form of the

consideration; for example, a lessee might contribute materials or labor for the construction or redesign of the underlying asset. [842-40-55-4]

9.4.60 If a lessee controls an underlying asset that is under construction (or redesign) before the commencement date – i.e. it is the ‘accounting owner’ of the asset – the transaction is a sale-leaseback transaction when construction is complete and the asset is available for use (usually at lease commencement), and the accounting described in sections 9.2 and 9.3 applies. [842-40-55-5]

9.4.70 In evaluating whether a lessee is the accounting owner of an asset under construction, Topic 842 focuses on whether the lessee controls the underlying asset before the lease commencement date (see paragraph 9.1.30). The guidance states that any one of the following characteristics would demonstrate that the lessee controls the underlying asset before the lease commencement date. [842-40-55-5]

- The lessee has the right to obtain the partially constructed underlying asset at any point during the construction period (e.g. by making a payment to the lessor).
- The lessor has an enforceable right to payment for its performance to date, and the asset does not have an alternative use to the owner-lessor.
- The lessee legally owns both the land and the property improvements that are under construction, or the non-real estate asset that is being constructed (e.g. a ship or aircraft).
- The lessee controls the land on which the property improvements will be constructed (which includes where the lessee transfers the land to the owner-lessor, but that transfer does not qualify as a sale – e.g. because of a lessee repurchase option) and does not enter into a lease of the land before the beginning of construction that, together with the renewal options<sup>1</sup>, permits the lessor or another related party to lease the land for substantially all of the economic life of the property improvements.
- The lessee is leasing the land on which the property improvements will be constructed, the term of which, together with lessee renewal options<sup>1</sup>, 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.<sup>1</sup>

Note:

1. ‘Options’ refers to all renewal options, regardless of whether it is reasonably certain that those options will be exercised. Therefore, this criterion considers the maximum possible lease term, rather than the ‘lease term’ as defined in Topic 842 (see section 5.3).

9.4.80 The list in paragraph 9.4.70 is not exhaustive. There may be other facts or circumstances that demonstrate that a lessee controls an underlying asset that is under construction before the commencement date. See Question 9.4.50. [842-40-55-5]



### Question 9.4.10

#### Lessee call option – exercisable only on occurrence of a contingent event

**Does a lessee call option that is contingent on a future event affect whether or when control of the underlying asset transfers to the lessee?**

**Background:** A lessee call option may not be exercisable at the beginning of the construction period. The option's exercisability may depend on the occurrence of a contingent event.

Question 9.4.11 addresses situations where only the passage of time is required for the option to become exercisable.

**Interpretive response:** A call option does not have to be unconditional to transfer control of the underlying asset to the lessee. Whether a contingency precludes, or changes the timing of, lessee control of the underlying asset depends on whether the contingency is within the lessee's control – e.g. the contingent event permitting exercise of the call option is a default on the construction timeline and the lessee is the construction manager.

#### Contingency within lessee's control

A contingency that is within the lessee's control is effectively ignored when determining whether, or when, the lessee obtains control of the underlying asset.

For example, assume construction of an underlying asset begins on January 1, 20X1. The lessee has an enforceable option to acquire that asset during the construction period that is exercisable only on the occurrence of a contingent event within the lessee's control. The lessee could cause that contingent event to occur any time from the beginning of the construction period. There are no other contingencies to the exercisability of the option. In this example, we believe the lessee is the accounting owner of the underlying asset from January 1, 20X1 (the date construction of that asset began).

#### Contingency not within lessee's control

If a lessee call option becomes exercisable only on a future contingent event that is not within the lessee's control, the lessee becomes the accounting owner of the underlying asset when the option becomes exercisable – i.e. when the contingency is resolved and there are no further contingencies outside of the lessee's control that preclude the lessee's exercise of the option.



### Question 9.4.11

#### **Lessee call option – exercisable only at a future date**

**When does a lessee call option for which the only contingency is the passage of time transfer control of the underlying asset to the lessee?**

**Background:** A lessee call option may not be exercisable at the beginning of the construction period. However, unlike in Question 9.4.10, it may be that only the passage of time is required for the option to become exercisable. For example, a lessee option to purchase the underlying asset may only become exercisable six months after construction has begun.

**Interpretative response:** Control of the underlying asset transfers at the point in time that passage of time becomes the only contingency preventing lessee exercisability of the option to acquire the underlying asset.

For example, assume construction of an underlying asset begins on January 1, 20X1. The lessee has an enforceable option to acquire that asset during the construction period that is exercisable beginning on July 1, 20X1. There are no other contingencies to the exercisability of the option either before or after July 1, 20X1. In this case, we believe the lessee is the accounting owner of the underlying asset from January 1, 20X1.



### Question 9.4.12

#### **Lessee call option – expires before the end of the construction period**

**Does a lessee call option that expires before the end of the construction period affect whether or when control of the underlying asset transfers to the lessee?**

**Background:** A lessee call option that would transfer control of the underlying asset to the lessee may not be exercisable throughout the construction period; it may expire before construction is complete. For example, after a certain point in the construction process, the lessor (and legal owner) may no longer be willing to permit the lessee to acquire the underlying asset.

**Interpretive response:** We do not believe expiration before the end of the construction period affects whether, or when, a call option conveys control of the underlying asset to the lessee. Even if the call option was the only factor resulting in the conclusion that the lessee was the accounting owner of the underlying asset, the lessee would still apply the sale-leaseback guidance to determine when it transfers control of the asset to the lessor. This means, consistent with Question 9.1.25, the lessee cannot derecognize the underlying asset once it has been deemed the accounting owner before commencement of the lease.



### Question 9.4.15 Meaning of 'at any point'

**Can a lessee obtain control of an underlying asset under construction if it has a call option that is not exercisable at all times during the construction period?**

**Background:** Topic 842 indicates that a lessee is the accounting owner of an asset under construction that it will lease if it has the right to obtain the partially constructed underlying asset 'at any point' during the construction period. 'At any point' could be interpreted as the lessee having the right to obtain the underlying asset (1) at all times during the construction period or (2) at some point during the construction period.

**Interpretive response:** Yes. It is *not* necessary for a call option to be exercisable at all times during the construction period, or even at all times after it first becomes exercisable. Once a call option becomes exercisable during the construction period (e.g. by resolution of a contingency or the occurrence of a stated event), the lessee is deemed to be the accounting owner of the asset. Even if the call option is not exercisable at all times from that point until construction is complete, the lessee remains the accounting owner until the transaction qualifies as a sale under the sale-leaseback guidance (see section 9.1).



### Question 9.4.20 Lessor put options

**Do lessor put options ever result in a conclusion that the lessee controls an asset under construction?**

**Interpretive response:** While the guidance in Subtopic 842-40 only refers to lessee call options transferring control of the underlying asset to the lessee, we believe control would also be transferred if the lessor has a 'significant economic incentive' to exercise a put option – i.e. an option to force the lessee to purchase the underlying asset under construction. Our view is based on the repurchase agreements guidance in Topic 606, which states that the seller of a good controls that good if the customer has a significant economic incentive to exercise an option to put the good back to the seller. [606-10-55-72]



### Question 9.4.30

#### Land lease (or sublease) at below-market rent

**Does below-market rent charged by the lessee for a lease or sublease to the owner-lessor of the land on which property improvements to be leased by the lessee are to be constructed, affect whether the lessee controls those improvements?**

**Interpretive response:** Nominal or below-market rent, by itself, would not result in a conclusion that the lessee controls (i.e. is the accounting owner of) the property improvements that are under construction on the leased (or subleased) land.

If, irrespective of the below-market rent (even if the payments are only nominal), the lessor controls the use of the land for substantially all the economic life of the property improvements, the fact that the rent is below market does not alone change the conclusion that would be reached if the land lease (or sublease) were at market terms.

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### Question 9.4.40

#### Lessee participation in construction period financing

**Does lessee participation in the construction period financing of the lessor mean the lessee controls the underlying asset during the construction period?**

**Background:** The lessee in a build-to-suit arrangement may either (1) provide construction financing to the lessor or (2) merely participate in that financing in a manner similar to that discussed in Question 9.1.80.

**Interpretive response:** By itself, no. In isolation, providing a loan to the lessor or participating in the lessor's third-party financing does not cause the lessee to meet any of the five conditions in paragraph 9.4.70 or otherwise indicate that the lessee controls (see paragraph 9.1.30) the underlying asset during the construction period.

However, as discussed in Question 9.1.80, other terms and conditions associated with providing the financing, or otherwise participating in third-party financing, may transfer control of the underlying asset to the lessee. For example, if the lessee provides a loan to the lessor to fund construction, and can take ownership of the underlying asset if the lessor defaults, consistent with the discussion in Question 9.4.10, the lessee would control the asset if it can induce a loan default. Similarly, if, as a condition of its involvement in the lessor's third-party financing, the lessee has the right to purchase the asset if the lessor defaults, the lessee would control the asset if it can induce the loan

default – e.g. if the lessee is the construction manager and construction delays can trigger a default by the lessor on its third-party financing. Even if the lessee cannot induce a default, a term that provides the lessee the right to purchase the asset upon a lessor default would give control of the asset to the lessee at the point in time the lessor actually defaults.

A guarantee of the lessor's debt is excluded from the lease payments (unless the guarantee is in substance a residual value guarantee – see Question 5.4.100), but would still need to be considered under Topic 460.

[\[842-10-30-6\(b\)\]](#)



### Question 9.4.50

#### Other considerations that demonstrate lessee control of an asset under construction

**In addition to the factors in paragraph 842-40-55-5, what should an entity consider in determining whether a lessee controls an underlying asset that is under construction before the commencement date?**

**Background:** In addition to the factors that are outlined in paragraph 9.4.70, paragraph 842-40-55-5 states that 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." However, Topic 842 does not provide examples of such circumstances. As a result, questions have arisen about what those other circumstances might be.

**Interpretive response:** In addition to the factors outlined in paragraph 9.4.70, an entity should evaluate whether the entity's performance creates or enhances an asset (e.g. work in process) that the customer (lessee) controls as the asset is created or enhanced. This is a control-based test that is different from the previous risk-based build-to-suit evaluation under Topic 840 (see paragraphs 9.4.90 – 9.4.120).

This evaluation, which is explained below, is consistent with one of the factors considered under Topic 606 in determining whether a performance obligation is satisfied, and revenue recognized, over time. [\[606-10-25-27\(b\)\]](#)

#### The factors considered under Topic 606

The Board observed that, in concept, the evaluation of whether a lessee controls an underlying asset that is under construction is similar to the evaluation undertaken in Topic 606 to determine whether a performance obligation to transfer a good is satisfied over time. [\[ASU 2016-02.BC400\(b\)\]](#)

Under the guidance in Topic 606, a customer obtains control of a good as it is being produced (or modified), and therefore the entity satisfies its performance obligation to transfer that good and recognizes revenue over time, when the entity's performance: [\[606-10-25-27\(b\) – 25-27\(c\)\]](#)

- creates or enhances an asset (e.g. work in process) that the customer controls as the asset is created or enhanced; and/or

- does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.

The second test is consistent with one of the factors listed in paragraph 9.4.70: 'The lessor has an enforceable right to payment for its performance to date, and the asset does not have an alternative use to the owner-lessor'. Therefore, only the first test is relevant to 'other' factors.

In the context of leasing, the first test can be translated as assessing whether the lessee controls the underlying asset as it is being constructed.

### **Assessing whether the lessee controls the underlying asset as it is being constructed**

#### ***Control indicators in 606-10-25-30***

Topic 606 does not provide substantial guidance relevant to applying the 'first test'. Topic 606 merely refers to the control principle and related control guidance in paragraphs 606-10-25-23 – 25-26 and paragraph 606-10-25-30; see section 7.3.30 of KPMG Handbook, [Revenue recognition](#). Because Topic 606 makes such reference, entities should consider that guidance in this leasing context (e.g. consider relevant evidence provided by the control indicators in paragraph 606-10-25-30). [\[606-10-55-7\]](#)

#### ***Owner-lessor control***

We believe one way of approaching the analysis in the context of this question is to look at whether the *owner-lessor* controls the underlying asset during the construction period – i.e. rather than the lessee. This is on the basis of the Board's belief, expressed in the basis for conclusions to ASU 2016-02, that it would be incompatible with the conceptual definition of an asset for two entities to control the same asset at the same time. Taking this approach, a conclusion under Topic 606 that a third party (or the lessee) constructing the asset for the owner-lessor should recognize revenue for the construction over time because the owner-lessor controls the construction in process means the lessee cannot also contemporaneously control the construction in process.

[\[ASU 2016-02.BC371\]](#)

Taking this approach to circumstances when none of the factors in paragraph 9.4.70 are met may be easier, and provide more clear-cut evidence for the evaluation, than trying to assess whether the lessee controls the construction in process. This is because it may be clear that the owner-lessor controls the construction in process, and therefore that the lessee does not. For example, consistent with the discussion in the basis for conclusions to ASU 2014-09, in the case of a construction contract in which a building is being constructed on the owner-lessor's owned or leased land, and the owner-lessor has not leased (or subleased) that land, it would generally be the case that the owner-lessor controls the construction in process. [\[ASU 2014-09.BC129\]](#)

#### **Factors that are not relevant**

Factors not directly relevant to assessing whether the lessee controls – i.e. has the ability to direct the use of, and obtain substantially all the remaining benefits from – the underlying asset as it is being constructed should not be considered. This includes factors that would have been considered under Topic 840 (see paragraphs 9.4.90 – 9.4.120).

For example, the lessee performing the following would generally *not* indicate that the lessee controls the construction in process:

- acting as the construction agent or general contractor for the project; and/or
- purchasing the construction materials and/or paying subcontractors – e.g. to leverage the lessee's purchasing power with relevant vendors or contractors.

Those activities, in isolation, would not, for example, permit the lessee either to sell the construction in process and realize its remaining benefits or prevent the lessor from doing so. Therefore, they do not of themselves suggest that the lessee controls the underlying asset. Such activities may *accompany* a conclusion that the lessee controls the construction in process, but would not directly lead to that conclusion.



#### Example 9.4.10

#### Determining whether a lessee controls the underlying asset before the commencement date (1)

Lessee LE and Owner-Lessor LR enter into a contract whereby LR will construct (whether itself or using subcontractors) a building to LE's specifications and lease that building to LE once construction is completed. The following facts are relevant.

Economic life of building:	40 years
Lease term:	20 years
Lease payments:	Fixed payments of \$500,000 per year in arrears, with a 3.5% increase each year after Year 1
Cost overruns:	Agreed percentage payable by LE

In addition:

- LE does not legally own the building and does not have a right under the contract to obtain control of the building while it is under construction. For example, LE does not have the right to purchase the construction-in-process from LR.
- Although the building is being developed to LE's specifications, it is not so customized to LE that the building does not have an alternative use to LR.

#### Scenario 1: Lessee controls the building as it is being constructed

LE controls the land on which the building is to be constructed. As part of the contract, LE agrees to lease the underlying land to LR for 25 years, beginning at the end of the construction period. The contract does not permit LR to renew the land lease.

In this scenario, LE controls (i.e. is the accounting owner of) the building as it is being constructed, because:

- LE controls the land on which the building will be constructed; and
- the lease of the building does not both (1) grant LR the right to use the land before the beginning of the construction period, and (2) permit LR to use the land for substantially all of the economic life of the building – it grants LR the right to use the land for only 25 years out of an estimated economic life of 40 years.

Because LE controls the building before lease commencement, the arrangement is accounted for as a sale-leaseback transaction (see sections 9.1 – 9.3). Starting from the beginning of construction, LE will therefore recognize the building as a construction-in-process asset with a corresponding liability for construction costs funded by LR. LE will only derecognize that asset and liability when a successful sale is concluded under the sale-leaseback guidance.

#### **Scenario 2: Lessee does not control the building as it is being constructed**

LE leases the land on which the building is to be constructed. LE has a 20-year lease of the underlying land, and four seven-year renewal options – i.e. the lease has a maximum possible term of 48 years. Therefore, LE's lease of the underlying land, together with the renewal options, is for at least substantially all of the economic life of the building under construction.

LE enters into a sublease that gives LR the right to use the underlying land for 25 years, commencing immediately before the beginning of construction of the building. The sublease has two 10-year renewal options available to LR.

None of the circumstances outlined in paragraph 9.4.70 exists.

- LE is neither the legal nor the accounting owner of the land, and will not legally own the building while it is being constructed.
- LE does not have the right to obtain the building (e.g. by purchase) from LR during the construction period.
- The building has an alternative use to LR.
- While LE is leasing the land on which the building will be constructed, LE has subleased that land to LR before the start of construction for a term that, together with renewal options available to LR, is at least substantially all of the 40-year economic life of the building (45 years exceeds the 40-year economic life of the building).

In this scenario, there are no other circumstances that, individually or in combination, suggest that LE controls the building as it is being constructed. Therefore, the arrangement is not subject to the sale-leaseback guidance in Subtopic 842-40.

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### Example 9.4.20

#### Determining whether a lessee controls the underlying asset before the commencement date (2)

Lessee LE and Owner-Lessor LR enter into a contract whereby LR will construct a manufacturing facility that LE will lease from LR for 15 years once constructed.

The following are key facts about the transaction.

Legal ownership of land and building:	LR
Lessee options to purchase the CIP:	None
Economic life of building:	40 years
Lease of land and building:	15 years
Lease renewal or purchase options:	None
Alternative use for the building:	Yes
See (4) below.	
Enforceable right to payment for work to date:	No
See (5) below.	

In addition:

1. LE is serving as the general contractor for the project – i.e. LE will manage and direct the construction of the facility. LE is experienced in constructing similar manufacturing facilities.
2. LE will procure materials and subcontractors for the construction and will pay those vendors. LR will reimburse LE for 100% of those costs. The arrangement is structured this way to take advantage of LE's significant purchasing power with vendors.
3. LE will specify the key aspects of the facility's design, layout and other pivotal specifications.
4. The facility would be suitable for use by numerous manufacturers other than LE, and there are no contractual restrictions preventing such use if LE were to terminate the arrangement.
5. If LE were to terminate the agreement during construction, LE would not owe LR for the costs of construction to date; however, it may owe some damages for breach of contract.
6. LE is expected to install significant leasehold improvements, but is required to remove them at the end of the lease. Once LE installs its specialized leasehold improvements, there would be a significant cost to rework the facility for another manufacturer.

#### Evaluation

LE does not control the construction in process and therefore this arrangement is not subject to the sale-leaseback guidance in Subtopic 842-40.

LE and LR each undertake the following evaluation in reaching this conclusion.

### **Step 1: Evaluation of the factors in paragraph 9.4.70**

LE and LR both conclude that none of the factors in paragraph 9.4.70 are present.

- LE does not have the option to acquire the underlying asset during the construction period.
- As described in the fact pattern, the construction in process has an alternative use to LR. Once LE installs its specialized leasehold improvements, there would be a significant cost to rework the facility for another manufacturer. However, this does not influence the analysis of whether LE controls the underlying asset during the construction period because:
  - once LE is permitted and able to begin installing its leasehold improvements, the lease has commenced (see section 5.1); and
  - LR would not incur the cost of the rework; LE is required to remove its leasehold improvements at the end of the lease.
- LE does not own the land and the construction in process. LR owns both.
- LE does not control the land on which the underlying asset is being constructed.
- LE's lease of the underlying land does not commence at the start of construction; nor is it for a period (together with available renewal options, of which there are none) that is at least substantially all the economic life of the building being constructed.

### **Step 2: Consideration of 'other factors' besides those in paragraph 9.4.70**

Subsequent to concluding that none of the factors in paragraph 9.4.70 are present, LE and LR both conclude that LR controls the construction in process and, therefore, that LE does not. Their analysis in this regard considered all of the following.

- During the construction period, it is LR that would be permitted to sell the construction in process (with the associated lease) and obtain any cash flows from that sale (e.g. if land values go up during the construction period), and potentially to use the land and the construction in process as collateral.
- None of the key facts of the transaction suggest that LE has the ability to direct the use of and obtain substantially all the remaining benefits from the construction in process. LE has no similar rights to those of LR in the preceding bullet, nor can it obtain any of the economic benefits listed in paragraph 606-10-25-25(a-f).
- A contractor (whether LE or an unrelated third party) constructing this building for LR as its customer would likely recognize revenue for the construction over time on the basis of the criterion in paragraph 606-10-25-27(b). This is because the facility is being constructed on LR's land and, as noted in Step 1, LE does not control, or control the use of, the land for at least substantially all the economic life of the facility being constructed. And because LR controls the facility as it is being constructed, LE cannot also control the facility contemporaneously.



### Question 9.4.60

#### Lessor accounting when lessee controls the underlying asset under construction

**When a lessee controls (i.e. is the accounting owner of) an underlying asset that is under construction before the lease commencement date, does the lessor account for the arrangement as a sale-leaseback transaction?**

**Interpretive response:** Yes. The lessor accounts for its costs to construct the asset as a loan to the lessee to construct the lessee's asset. At the end of the construction period, the lessor applies the sale-leaseback guidance to determine whether (and when) to recognize the underlying asset.

This conclusion, which was confirmed in discussions with the FASB staff, is based on the following.

- Because the transaction includes a lease, Topic 842 is the prevailing guidance. And under Topic 842, if the lessee controls the underlying asset before the commencement date, the transaction is accounted for as a sale-leaseback transaction. This guidance is not limited to the lessee. [842-40-55-1, 55-5]
- Example 3 Case B in Topic 842 concludes that the lessee controls the underlying asset that is under construction, and states that as a result, "Lessee and Lessor will apply the guidance in this Subtopic to determine whether this arrangement qualifies as a sale and leaseback ..." [emphasis added] [842-40-55-44]
- It was the Board's intent to apply symmetrical accounting in terms of control of an asset within the context of the sale-leaseback guidance and that an entity should not account for an asset it does not control in accordance with Concepts Statement 6 (elements of financial statements). The clear implication is that two entities (in this case, the lessee and the lessor) cannot control the same asset (i.e. the asset under construction) concurrently. This was decided upon by the Board in an August 2014 FASB meeting, and confirmed by Board members as their intent in a preparer-group liaison meeting in 2015 before the issuance of ASU 2016-02. [ASU 2016-02.BC371]
- The build-to-suit guidance in Topic 842 is based on the over-time revenue recognition guidance in Topic 606, and TRG discussions were clear that a seller should not recognize an asset for a good being transferred to the customer over time. Applying that same approach, if the lessee controls the asset as it is being constructed, the lessor should not recognize the underlying asset. [606-10-25-27, TRG 04-16.53, ASU 2016-02.BC400(b)]



### Question 9.4.70

#### Accounting for the transfer of construction-in-progress in a build-to-suit scenario

### How do the lessee and the lessor account for the transfer of existing construction-in-progress from the lessor to the lessee?

**Background:** The underlying asset that needs to be constructed or redesigned in a build-to-suit lease (see paragraph 9.4.40) is frequently not a brand new asset. The lessor may have the underlying asset on its books already as construction-in-progress (CIP).

For example, Lessee LE and Lessor LR enter into an arrangement to lease a building upon its completion. Based on the facts and circumstances, LE is determined to control (i.e. be the accounting owner of) the underlying asset during the construction period (see paragraph 9.4.70 and Question 9.4.50). At contract inception, LR has already incurred \$20 million in construction costs, recognized as CIP on its books. The CIP has a fair value of \$22 million. It is expected that the completed building will cost a total of \$50 million and have a fair value of \$55 million.

**Interpretive response:** We believe the **lessee** should recognize the existing asset as CIP at its then-current fair value with a corresponding financial liability. In the background example, this means that at contract inception, LE should recognize CIP and a financial liability, each of \$22 million.

Assuming the construction continues to be financed by the lessor, the lessee should increase the CIP and the financial liability as the construction occurs, just as it would if the underlying asset was new construction at contract inception.

We believe the **lessor's** accounting depends on whether it has the obligation (as a principal) to complete the underlying asset's construction, or instead is acting solely as a financing agent for the construction. In many cases, the lessor agrees, regardless of whether it will engage one or more subcontractors to perform some or all of the construction work, to complete the construction as part of the contract with the lessee. By contrast, the lessor may solely have an obligation to finance the underlying asset's completion, while another party (or the lessee itself) undertakes the obligation to complete the asset's construction. We believe the principal-agent considerations guidance in Topic 606 (revenue from contracts with customers) provides a relevant framework to make this determination; see chapter 9 of KPMG Handbook, [Revenue recognition](#).

#### **Lessor has obligation to complete the construction**

The lessor should recognize a receivable equal to the sum of the (1) contract inception carrying amount of the existing asset and (2) proportionate gross profit.

Proportionate gross profit equals the portion of the total gross profit earned to date based on an appropriate Topic 606 measure of progress toward

construction completion; see section 7.4 of KPMG Handbook, [Revenue recognition](#).

We believe total gross profit in these scenarios equals the difference between (1) the expected fair value of the underlying asset upon completion; and (2) the expected total costs of construction (\$5 million in the background example).

#### **Topic 606 control requirements vs. Topic 842 build-to-suit requirements**

We acknowledge that if the lessee does not have an option to purchase the CIP or the completed underlying asset, or has a significant economic incentive not to exercise such an option (and therefore, in effect, put the asset back to the lessor), Topic 606 or Subtopic 610-20 would conclude that the lessee does not control the CIP as it is being constructed. [\[606-10-55-68, 55-72 – 55-73\]](#)

However, Topic 842 expressly assigns control of the CIP to the lessee from both the lessee and lessor perspective. We believe this overrides the repurchase agreements guidance in Topic 606, resulting in the above accounting for the lessor that treats the CIP as transferring to the lessee over time as construction progresses. [\[842-40-55-5, ASU 2016-02.BC371\]](#)

#### **Lessor does not have obligation to complete the construction**

The lessor should derecognize the underlying asset and recognize a receivable equal to the contract inception date fair value of the asset. Any difference between the two should be recognized as a gain or loss on the asset's sale.

In the background example, if LR determines that it does not have an obligation to complete the underlying asset's construction, it should:

- derecognize the \$20 million CIP asset;
- recognize a receivable of \$22 million from LE; and
- recognize a \$2 million gain on sale of the CIP.

In this case, any further costs of construction the lessor finances should be recognized as additions to the receivable.



#### Question 9.4.80

#### **Build-to-suit applicability when an underlying asset is modified**

#### **Does the build-to-suit lease guidance apply when the underlying asset is modified after the commencement date?**

**Background:** To illustrate this question, consider the following example.

Lessee LE and Lessor LR have an existing manufacturing facility lease. At the end of lease Year 4, LR agrees to:

- expand the facility's footprint with the intent to increase the manufacturing floor space; and
- upgrade the facility's HVAC and electrical infrastructure to accommodate new equipment the lessee intends to install.

**Interpretive response:** The build-to-suit guidance applies to 'underlying assets being constructed before the commencement date' (see paragraph 9.4.10). [842-40-55-5]

Therefore, we do not believe it applies when an underlying asset is modified after the commencement date unless the changes in effect create a *new* commencement date because the lessee loses control over the use of the asset while it is being modified or enhanced.

When making this evaluation, an entity should consider whether:

- the lessee will continue to use the asset during the construction period and, if so, how;
- the modifications to the asset are lessee-owned improvements (see Questions 5.4.80 and 5.4.81); if so, the lessee controls the use of the underlying asset while those improvements are made even if it must cease its other use(s) of the asset during that time; and
- the modifications are themselves one or more separate 'underlying assets'; if so, see Question 9.4.85. [842 Glossary]

If the build-to-suit guidance applies, the parties need to determine if the lessee is the accounting owner of the underlying asset being modified during the construction period of the modifications (see paragraph 9.4.70 and Question 9.4.50).

And regardless of whether the build-to-suit guidance applies, the lessee and the lessor need to consider whether the changes to the underlying asset and/or other changes to the lease (e.g. a lease term extension agreed to in return for LR expanding the manufacturing facility in the background example) trigger a lease modification and, if so, account for that modification. See sections 6.7 and 7.6 for the lessee and lessor modification guidance, respectively.

## Question 9.4.85

### Identifying the underlying asset under construction

#### What constitutes the underlying asset under construction when an existing underlying asset is modified?

**Background:** To illustrate this question, consider the following scenarios.

- The contract for an existing warehouse lease is modified. The lessor agrees to double the size of the leased warehouse by building a separate space directly adjacent to the existing warehouse footprint and sharing the existing exterior wall – i.e. the formerly exterior wall will now be an interior wall separating the existing warehouse space from the new warehouse space.
- The contract for an existing manufacturing facility lease is modified. The lessor agrees to increase the facility's footprint to increase the manufacturing floor space and upgrade the entire facility's HVAC and electrical infrastructure to accommodate new equipment the lessee intends

to install. Unlike the warehouse scenario, there will be no physical separation of the pre-existing and new manufacturing floor space.

In these scenarios, the question arises about whether the entire building (i.e. the warehouse, including the existing and the new space, and the manufacturing facility) must be considered for lessee accounting ownership (see paragraph 9.4.70 and Question 9.4.50).

**Interpretive response:** If the asset modification meets the definition of an 'underlying asset' – i.e. the customer will obtain the right to use it once complete and it is physically distinct (see section 3.2.2) – we believe the build-to-suit guidance applies only to the modification, and not to the pre-existing asset (see Question 9.4.80). [\[842 Glossary\]](#)

This is because the build-to-suit guidance explicitly applies to an 'underlying asset' being constructed before the commencement date. Therefore, if there are multiple underlying assets, each is its own unit of account for applying the build-to-suit guidance. [\[842-40-55-5\]](#)

When an asset modification meets the definition of an underlying asset on its own, the lessee and lessor will not, even if the lessee is determined to be the accounting owner of the modification, recognize and derecognize the original underlying asset, respectively.

This applies as follows to the two background scenarios.

— **Warehouse.** By virtue of its physical separation from the pre-existing warehouse space (via the formerly exterior wall), the new warehouse space is a physically distinct space over which the lessee will obtain a right of use under the modified contract. Therefore, the new warehouse space is its own unit of account, separate from the pre-existing warehouse, for purposes of applying the build-to-suit guidance. The lessee does not capitalize as its own asset, nor the lessor derecognize, the pre-existing warehouse if the lessee is determined to be the accounting owner of the new warehouse space.

We do not believe this conclusion changes if the construction activities also include significantly modifying or redesigning the pre-existing warehouse space as long as the pre-existing warehouse space and the new warehouse space both meet the definition of an underlying asset. The lessee and the lessor would evaluate the build-to-suit guidance for the pre-existing warehouse space (see Question 9.4.80) separately from their build-to-suit considerations for the new warehouse space.

— **Manufacturing facility.** The changes to the manufacturing facility do not result in an additional underlying asset. Therefore, there is only one unit of account before and after the modification. The lessee and the lessor should consider Question 9.4.80 when deciding whether the build-to-suit guidance applies to this scenario.



### Question 9.4.90

#### **Lease of to-be-constructed property improvements on land sold by the lessee to the lessor**

**Does a seller-lessee control property improvements under construction on land it has legally sold to the buyer-lessor if the land sale does not occur for accounting purposes until lease commencement?**

**Background:** Assume a seller-lessee legally sells a plot of land to a buyer-lessor at fair value; legal transfer happens immediately and there is no repurchase option. Under the land sale contract, the buyer-lessor will construct a building (with an expected economic life of 40 years) on the land that the seller-lessee will lease, when completed, for 15 years. Because the seller-lessee will lease the entire building, there is an implied leaseback of the land (see paragraph 4.1.130). The leases of the land and the building will commence at the conclusion of the building's construction.

In Question 9.1.25, we discuss that we do not believe a sale (seller-lessee) or purchase (buyer-lessor) in a sale-leaseback can occur for accounting purposes under Subtopic 842-40 before the lease commencement date. Consistent with that Question, in this scenario, the seller-lessee remains the accounting owner of – i.e. continues to control – the underlying land during the building construction period. Because of this, the question arises about whether the seller-lessee is the de facto accounting owner of the building during the construction period.

**Interpretive response:** We do not believe the fact that the seller-lessee remains the accounting owner of the land during the building construction period (and therefore, does not derecognize it), in itself, means the seller-lessee controls the building being constructed on that land during that period.

This is because, despite the seller-lessee's continued *accounting* ownership of the land during the building construction period, *legal* ownership of the land has transferred. In addition, the seller-lessee has ceded control *over the land's use* to the buyer-lessor, consistent with the second part of paragraph 842-40-55-5(d), in perpetuity, beginning with the buyer-lessor's right to use the land to construct the building.



### Comparison to legacy US GAAP

#### **Lessee control over asset under construction guidance different from legacy US GAAP**

9.4.90 Topic 842 and Topic 840 both treat the lessee as the accounting owner of an underlying asset that is under construction in some circumstances and, in these situations, the transaction is subject to the sale-leaseback guidance. However, Topic 842 and Topic 840 determine whether the lessee is the

accounting owner of an underlying asset that is under construction differently. [840-40-15-5]

9.4.100 Under Topic 840, the lessee was the accounting owner of the asset during the construction period if the lessee either:

- took on substantially all of the construction-period risks, determined through a ‘maximum guarantee test’; or
- engaged in one or more activities specifically outlined in the guidance as prohibited involvement. Such activities included, but were not limited to, indemnifying the owner-lessor or its lenders for preexisting environmental risks (when the risk of loss was more than remote), taking title to the asset at any point during the construction period, being obligated to pay for construction cost overruns, and paying construction project costs directly (other than some limited exceptions).

9.4.110 Topic 842 eliminates the build-to-suit guidance in Topic 840 about determining whether a lessee controls the underlying asset during the construction period. Instead, it requires an evaluation of whether a lessee is the accounting owner of an underlying asset under construction based on whether it ‘controls’ that asset before the commencement date of the lease. [840-40-55-2 – 55-15]

### **Lessor accounting for build-to-suit lease arrangements different from legacy US GAAP**

9.4.120 As outlined in Question 9.4.60, in the absence of further guidance we believe the guidance in Subtopic 842-40 on lessee control of an underlying asset that is under construction before the commencement date applies to lessors as well as lessees. In contrast, Topic 840 did not provide guidance for lessors in build-to-suit lease arrangements. Under Topic 840, regardless of whether the lessee was deemed the accounting owner of an asset under construction, the lessor would typically have the construction-in-progress on its balance sheet and would not apply the sale-leaseback guidance to the transaction after the construction period was complete.

## 9.5 Transfer of tax benefits



### **Excerpt from ASC 842-40**

#### **55 Implementation Guidance and Illustrations**

##### **General**

- > Implementation Guidance
- > Transfer of Tax Benefits

**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.



## Question 9.5.10

### Sale of tax benefits

#### When does the sale of an ownership interest in an asset result in sale-leaseback accounting?

**Background:** A sale of tax benefits is often structured in a way that appears similar to a sale-leaseback transaction. The following is a summary.

- The seller sells an ownership interest (but not necessarily title) in the underlying asset to the buyer, such that the buyer can claim a tax benefit in its jurisdiction. [842-40-55-11]
- The seller then leases back that ownership interest from the buyer. [842-40-55-12]
- The parties to this transaction determine whether the transfer of the ownership interest is a sale based on the guidance in paragraphs 842-40-25-1 – 25-3. If the transfer is not a sale, the seller accounts for the cash received for the ownership interest as a financial liability. [842-40-55-15]

**Interpretive response:** Because each party is attempting to determine whether the transaction is a sale and a leaseback, we believe the pertinent question is whether the buyer's acquisition of the ownership interest conveys control of the underlying asset to the buyer.

In that regard, either of the following would preclude accounting for the transfer of the ownership interest as a sale and a leaseback of the underlying asset: [842-40-25-2 – 25-3]

- the leaseback would be classified as a finance lease; or
- the seller has an option to repurchase the ownership interest that does not meet the two criteria in paragraph 9.1.50.

If neither of those conditions are met, we believe whether or not there is a sale of the underlying asset depends on whether the buyer obtains rights with respect to the underlying asset (through its ownership interest) that are equivalent to those a typical buyer-lessor obtains in a successful sale-leaseback transaction (see paragraphs 9.1.70 – 9.1.90). If so, then the parties will account for the transfer of the ownership interest (and the seller's retention of the right to use the underlying asset) as a sale-leaseback. If not, the cash payment for the ownership interest should be accounted for as a financing by both parties. In general, we expect that if there is a difference in the rights that the buyer actually obtains through its ownership interest compared to the rights that it would obtain if title to the underlying asset were conveyed, that the rights conveyed to the buyer will not be equivalent to those a typical buyer-lessor obtains in a successful sale-leaseback transaction.



## Comparison to legacy US GAAP

### **Transfer of tax benefits guidance is affected by the requirement to consider control**

9.5.10 Under Topic 840, entities often considered the guidance in the 1981 FASB Exposure Draft, *Accounting for the Sale or Purchase of Tax Benefits through Tax Leases*, which stated that an entity should account for a transaction that is a sale of tax benefits structured as a lease as the sale of a tax benefit only if it does not include elements commonly found in leasing transactions other than the transfer of tax benefits. The ED stated that if the transaction includes a financing element, or a transfer of an interest in the residual value of the asset, then the transaction was a lease rather than a sale of tax benefits.

9.5.20 Under Topic 842, the parties must conclude that control of the underlying asset has transferred to the buyer to conclude there is a sale-leaseback; otherwise, there is a financing transaction. The requirement to determine if there is a sale/purchase based on the guidance in Subtopic 842-40, and the requirement to account for transfers of tax benefits that do not meet the sale requirements as financing transactions constitute significant changes from Topic 840.

# 10. Income taxes

## Detailed contents

**Item significantly updated in this edition: #**

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- 10.1.2 Lease origination costs
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- 10.1.4 Lessor considerations
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#### Observation

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#### Comparison to legacy US GAAP

#### 10.2 State and local income tax implications

#### 10.3 Change in US Federal Tax Accounting Method

#### 10.4 Transfer pricing

## How the standard works

Topic 842 does not contain tax accounting guidance, and only minor, conforming amendments to Topic 740 (income taxes) were made as part of ASU 2016-02. These amendments do not change the basic requirements of Topic 740.

The adoption of Topic 842 will likely affect an entity's calculation of deferred tax assets and liabilities even though tax laws may not be directly affected. The following changes will have the greatest effect on an entity's accounting for deferred taxes.

- For **lessees**, the recognition of ROU assets and lease liabilities for operating leases will require entities to recognize new deferred tax assets and deferred tax liabilities not previously recognized.
- For **lessors**, the deferral of selling profit for some direct financing leases could create new (or larger) deferred tax assets.
- For **seller-lessees** and **buyer-lessors** in sale-leaseback transactions, a failed sale or failed purchase (see section 9.3) could result in new deferred tax issues if the sale-leaseback transaction is accounted for as a sale and a leaseback for tax purposes.

In addition, Topic 842 may affect the computation of state and local income-based taxes as a result of changes to the apportionment formula.

## 10.1 Deferred taxes

10.1.10 A basic principle of Topic 740 is to recognize deferred taxes for the future tax consequences of events that are recognized in the financial statements or tax returns, but not yet in both. Future tax consequences result from differences between the tax basis and the financial statement carrying amounts of assets and liabilities. Basis differences that have future tax consequences are either taxable temporary differences (which will result in future taxable amounts) or deductible temporary differences (which will result in future deductible amounts). Deferred tax liabilities are recognized for taxable temporary differences and deferred tax assets are recognized for deductible temporary differences.

10.1.15 Topic 842 does not include presentation or disclosure requirements for deferred tax assets and liabilities arising from leases. Topic 740 (income taxes) governs their presentation and disclosure. See chapter 9 of KPMG Handbook, [Accounting for income taxes](#).



### Question 10.1.05

#### **Disclosure of lease-related deferred taxes**

**Are deferred tax assets and liabilities arising from ROU assets and lease liabilities disclosed on a gross basis?**

**Interpretive response:** Yes. See paragraph 9.082a of KPMG Handbook, [Accounting for income taxes](#).



#### Comparison to legacy US GAAP

#### **Mechanics of income tax accounting remain unchanged**

10.1.20 Topic 842, consistent with Topic 840, will create book/tax differences. However, because Topic 842 results in the recognition of more assets and liabilities than Topic 840, the adoption of Topic 842 may require entities to record new, or adjust existing, deferred tax assets and liabilities.

10.1.30 Under Topic 840 for operating leases, a lessee generally recorded a deferred tax asset for the accrued rent liability that existed, which would equal the difference between the cumulative rent deductible for income tax purposes, sometimes based on the cash paid, and the cumulative rent recognized for book purposes (generally on a straight-line basis). Because neither the underlying asset nor the ROU asset was recognized by the lessee for book purposes, the only temporary difference created was the difference between the rent expense recognized for tax purposes and book purposes. However, because Topic 842 requires recognition of an ROU asset and a lease liability that have no tax basis, deferred tax accounts will be established to recognize these basis differences.

10.1.40 Aside from this difference, while the amounts may change due to the new requirements of Topic 842 in comparison to Topic 840, the mechanics of accounting for the income tax consequences of lease agreements remain substantially unchanged.

## 10.1.1 Lessee considerations – operating leases

10.1.50 Under Topic 842, a lessee in an operating lease records a lease liability and an ROU asset (see section 6.3) on the commencement date (see section 5.1). For tax purposes, the lease will generally be a true tax lease (the income tax equivalent of an operating lease), in which an ROU asset and a lease liability are not recognized on the tax ledger. As a result, the operating lease gives rise to two separate temporary differences: (1) a temporary difference related to the ROU asset, and (2) a temporary difference related to the lease liability. The measurement of the temporary difference resulting from the ROU asset will be affected by items such as uneven lease payments, initial direct costs and lease incentives, which each affect the measurement of the ROU asset throughout the lease term.

10.1.60 The following table highlights the effect of the guidance in Topic 842 on various combinations of book and tax lease classification for lessees.

<b>Book classification</b>	<b>Tax classification</b>	<b>Primary impact of Topic 842</b>
<b>Operating</b>	True tax lease (tax operating lease)	New deferred tax balances because lease assets and lease liabilities are created with no tax basis (see Example 10.1.20).
<b>Operating</b>	Non-tax lease (tax sales-type lease)	Smaller deferred tax balances because there will be book and tax basis lease assets and lease liabilities going forward, rather than only tax basis assets and liabilities.
<b>Finance</b>	True tax lease	No significant change; amounts may vary.
<b>Finance</b>	Non-tax lease	No significant change; amounts may vary.

## 10.1.2 Lease origination costs

10.1.70 Generally, for both lessees and lessors, costs incurred to originate a lease are capitalized for tax purposes unless they are de minimis (not exceeding \$5,000 in the aggregate per lease for US federal purposes), in which case they may be deductible.

10.1.80 Under Topic 842, many types of lease origination costs will not meet the definition of initial direct costs (see section 5.5), and therefore will be expensed as incurred for book purposes.

10.1.90 Those lease origination costs that meet the definition of initial direct costs are capitalized and recognized as an expense over the lease term. An exception is sales-type leases for lessors in which the fair value of the

underlying asset differs from its carrying amount at lease commencement. For those leases, initial direct costs are expensed at lease commencement (see section 7.3.1).

10.1.100 For lessees, initial direct costs are capitalized as a component of the ROU asset (see section 6.3), and as a result affect the measurement of the deferred tax liability associated with the ROU asset.



### Example 10.1.20#

#### Deferred tax measurement of operating leases under Topic 842 (lessee)

Lessee LE leases a building from Lessor LR. The lease is classified as an operating lease. LE has a tax rate of 30%. The following facts are also relevant.

- The total rent payments are \$166,535, which equals the sum of the lease payments for the term of the lease of \$14,527 in Year 1, and escalating 3% per year thereafter for a lease term of 10 years, paid in arrears.
- LE incurs \$5,000 in lease origination costs that do not meet the definition of initial direct costs under Topic 842, and therefore are expensed as incurred for book purposes.
- The lease is a true tax lease for income tax purposes, and the rent is deductible for tax purposes as paid.
- The rate implicit in the lease is not readily determinable, so LE uses its incremental borrowing rate of 10% as the discount rate for the lease.
- LE determines the cost of the lease to be \$166,535 (sum of the lease payments for the term of the lease of \$14,527 in Year 1 and escalating 3% per year thereafter for a lease term of 10 years). Therefore, the annual lease expense to be recognized for book purposes is \$16,654 (\$166,535 / 10 years).

#### At lease commencement

LE recognizes an ROU asset and lease liability.

	Debit	Credit
ROU asset	100,000	
Lease liability <sup>1</sup>		100,000
Note:		
1. Present value of the lease payments, discounted at 10%.		

For tax purposes, the ROU asset and the lease liability are not recognized, resulting in temporary differences, while the lease origination costs are deferred for tax purposes. Therefore, LE recognizes a deferred tax asset associated with the lease liability, a deferred tax liability associated with the ROU asset, and another deferred tax asset associated with the lease origination costs that are capitalized for tax purposes, but not for book purposes.

	<i>Debit</i>	<i>Credit</i>
Deferred tax asset <sup>1</sup>	30,000	
Deferred income tax expense (benefit) <sup>1</sup>		30,000
Deferred income tax expense (benefit) <sup>2</sup>	30,000	
Deferred tax liability <sup>2</sup>		30,000
Deferred tax asset <sup>3</sup>	1,500	
Deferred income tax expense (benefit) <sup>3</sup>		1,500

Notes:

1. \$100,000 carrying amount of the lease liability × 30%.
2. \$100,000 carrying amount of the ROU asset × 30%.
3. \$5,000 lease origination costs deferred for tax purposes only × 30%.

Lastly, LE expenses the lease origination costs as incurred for book purposes.

	<i>Debit</i>	<i>Credit</i>
Operating expense	5,000	
Cash		5,000

### During the first year of the lease

LE recognizes lease expense along with the lease payment as follows (for book purposes).

	<i>Debit</i>	<i>Credit</i>
Lease expense	16,654	
ROU asset amortization		6,654
Lease liability (interest accretion)		10,000
Lease liability	14,527	
Cash (Year 1 lease payment)		14,527

At the end of the first year of the lease:

- the carrying amount of the lease liability is \$95,473 (the present value of the nine future payments, discounted at 10%);
- the carrying amount of the ROU asset is \$93,346 (\$95,473 carrying amount of the lease liability – \$2,127 accrued rent [Year 1 lease cost of \$16,654 – Year 1 lease payment of \$14,527]); and
- the tax basis of the deferred lease origination costs is \$4,500 (\$5,000 – [\$5,000 initial balance / 10 years]).

Therefore:

- the carrying amount of the deferred tax asset related to the lease liability is \$28,642 (\$95,473 × 30%);
- the carrying amount of the deferred tax liability related to the ROU asset is \$28,004 (\$93,346 × 30%); and

- the carrying amount of the deferred tax asset related to the tax-deferred lease origination costs is \$1,350 ( $\$4,500 \times 30\%$ ).

LE records the following for book purposes related to income taxes to adjust the deferred tax asset and deferred tax liability for the changes in the carrying amount of the lease liability and the ROU asset, respectively; as well as to recognize the tax effect of the current year tax deductible payments.

	Debit	Credit
Deferred income tax expense (benefit) <sup>1</sup>	1,358	
Deferred tax asset <sup>1</sup>		1,358
Deferred tax liability <sup>2</sup>	1,996	
Deferred income tax expense (benefit) <sup>2</sup>		1,996
Deferred income tax expense (benefit) <sup>3</sup>	150	
Deferred tax asset <sup>3</sup>		150
Income taxes payable <sup>4</sup>	4,508	
Current income tax expense (benefit) <sup>4</sup>		4,508

Notes:

- \$30,000 initial deferred tax asset – \$28,642 end of Year 1 deferred tax asset related to the lease liability.
- \$30,000 initial deferred tax liability – \$28,004 end of Year 1 deferred tax liability related to the ROU asset.
- \$1,500 initial deferred tax asset – \$1,350 end of Year 1 deferred tax asset related to the origination costs.
- Tax deductible lease expense of \$15,027 (cash paid for Year 1 lease payment of \$14,527 + Year 1 tax amortization of lease origination costs of \$500)  $\times 30\%$ .

The total income tax benefit for Year 1 is therefore \$6,496 (\$4,508 current tax benefit + \$1,988 [\$1,996 – \$1,358 + (\$1,500 – \$150)] net deferred tax benefit), which equals 30% of the sum of (1) the book lease expense for Year 1 of \$16,654 and (2) the expensed lease origination costs of \$5,000.



### Question 10.1.10

#### Related party leases

### Do deferred tax assets or liabilities arise in related party leases under Topic 842?

**Interpretive response:** Yes. Under Topic 842, a related party lease is accounted for based on its enforceable terms and conditions (or its written terms and conditions if the practical expedient outlined in section 3.1.2 is being applied) – see section 6.2.2. In contrast, the tax treatment of such leases generally looks to the economic substance of the arrangement (i.e. similar to how such leases were accounted for under Topic 840). This can result in

temporary differences for entities that engage in leasing activities with related parties on other than arm's-length terms. [842-10-55-12, 740-10-25-2(b)]



### Question 10.1.15

#### Intercompany operating leases: REIT and taxable REIT subsidiary

#### Must a REIT retain its REIT subsidiary's deferred taxes on consolidation?

**Background:** In some REIT structures (e.g. hotel and some healthcare REITs), the REIT (parent company) owns a building and leases it under an operating lease to a REIT subsidiary (TRS) that either operates the property or contracts with a third party to operate the property.

As discussed in Question 10.1.10 and section 6.2.2, the TRS accounts for the intercompany lease in its stand-alone financial statements as if it were a lease between unrelated parties. Because the TRS is taxed like a corporate entity, it provides deferred taxes in its ledger for the book/tax basis differences related to its ROU asset and lease liability. The deferred taxes are based on the TRS's applicable tax rate. [842-10-55-12]

Like the TRS, the REIT accounts for the intercompany lease in its stand-alone financial statements as if it were a lease between unrelated parties. However, because the REIT is effectively taxed at a zero rate, it does not provide deferred taxes in its ledger for its book/tax basis differences related to the lease.

The operating lease is eliminated in consolidation.

**Interpretive response:** No. We do not believe the REIT must retain (or provide) deferred taxes in the consolidated financial statements for the intercompany operating lease because there are no book/tax basis differences associated with the lease after the REIT makes its elimination entries. Basis differences are identified based on the difference between the tax basis of an asset or liability and its reported amount in the consolidated statement of financial position. [740-10-25-20]

### 10.1.3 Lessee considerations – finance leases

10.1.110 For finance leases, a lessee recognizes the following (see sections 6.3 and 6.4.1):

- ROU asset (on the commencement date);
- lease liability (on the commencement date);
- interest expense on the lease liability each period of the lease term; and
- amortization of the ROU asset each period of the lease term.

10.1.120 A lessee amortizes the ROU asset on a straight-line basis, unless another systematic basis is more representative of the pattern in which the lessee expects to consume its economic benefits. Amortization is recognized over the period from the commencement date to the earlier of the end of the

useful life of the ROU asset or the end of the lease term. If the lessee is reasonably certain to exercise a purchase option to acquire the underlying asset, the lessee amortizes the ROU asset over the period to the end of the underlying asset's useful life.

10.1.130 For tax purposes, finance leases are often treated as either true tax leases or non-tax leases (the income tax equivalent of a sales-type lease). Under a true tax lease, the lessor maintains ownership of the asset and the related deductions for depreciation, and the lessee is able to deduct rental payments for use of the asset. Compare this with a non-tax lease: Although legal ownership of the asset remains with the lessor in a non-tax lease, the lessor is not considered to have substantial risks and rewards of ownership; the lease is more akin to a financing transaction because the lessee has a nominal purchase option at the end of the lease. As a result, the lessee receives the tax benefits of ownership and:

- is able to deduct (1) the related depreciation for the asset, and (2) the portion of the payments that are considered interest; but
- is not permitted to deduct the total rental payments. The lessor recognizes interest income.

10.1.140 It is possible for a finance lease to be classified as a true tax lease for tax purposes. In those situations, the lessee records an ROU asset and a lease liability at lease commencement, and subsequently will recognize interest expense and ROU asset amortization. For the tax provision, the lessee will have temporary differences related to the ROU asset and the lease liability because those do not exist for tax purposes.

#### 10.1.4 Lessor considerations

10.1.150 A lessor classifies leases as operating, direct financing or sales-type leases for book purposes. For tax purposes, those leases are generally treated as true tax leases or as non-tax leases, which are similar to a sales transaction.

10.1.160 For direct financing and sales-type leases, the present value of the lease payments during the lease term plus the present value of the expected residual value of the underlying asset at the end of the lease term is recognized as the lessor's net investment in the lease (see section 7.3.1). The deferral of selling profit for some direct financing leases may create new (or larger) deferred tax assets in that those leases will frequently be non-tax leases for tax purposes and the entire tax profit on the lease (sales price – tax basis of the asset) will be recognized for tax purposes at the time of sale.

10.1.170 In some jurisdictions and fact patterns, the lease may be considered a true tax lease, where the lessor will be considered to own the asset for tax purposes and will deduct the depreciation for the asset and recognize taxable income for the rental income. In other jurisdictions and fact patterns, the lease may be treated as a non-tax lease for tax purposes. In this situation, the lessor will recognize a taxable gain or loss on the sale of the asset and will recognize interest income over the lease term for the financing provided to the lessee that is repaid through the payments under the lease.

10.1.180 The deductible amount scheduled in each future year is based on the depreciation to be recognized for tax purposes in those future years. The taxable amount scheduled in each future year is generally based on the present value of amounts to be received in each future year or on the future principal reductions in the lease receivable.

10.1.190 The following table highlights the effect of the changes in Topic 842 on various combinations of book and tax lease classification for lessors.

<b>Book classification</b>	<b>Tax classification</b>	<b>Primary impact of Topic 842</b>
Operating	True tax lease	No significant change; amounts may vary
Operating	Non-tax lease	No significant change; amounts may vary
Sales-type	True tax lease	No significant change; amounts may vary
Sales-type	Non-tax lease	No significant change; amounts may vary
Direct financing	True tax lease	No significant change; amounts may vary
Direct financing	Non-tax lease	No significant change; amounts may vary <sup>1</sup>

Note:

- More significant changes from Topic 840 may result if under Topic 842 a direct financing lease results in selling profit that is required to be deferred and recognized over the lease term (see Example 10.1.30).



### Example 10.1.30

**Lessor – direct financing lease for book purposes treated as non-tax lease for tax purposes**

Lessor LR leases a piece of equipment to Lessee LE. The following facts are relevant at the commencement date.

Lease term:	3 years
Lease payments:	Fixed payments of \$10,500 per year (paid in arrears); no variable lease payments
Lease options:	None
Expected future residual value:	\$12,500
RVG:	\$9,200 (third party other than LE)
Initial direct costs:	None
Rate implicit in the lease:	4.29%
Fair value:	\$40,000
Tax basis:	\$29,000
Book carrying amount:	\$36,000
Remaining economic life of equipment:	5 years
LR's tax rate:	30%

For book purposes, the lease is a direct financing lease. For tax purposes, the lease qualifies as a non-tax lease and therefore it is treated as a sale for income tax purposes.

At lease commencement, LR recognizes the following for book purposes (exclusive of income tax effects).

	Debit	Credit
Lease receivable <sup>1</sup>	37,091	
Unguaranteed residual asset <sup>2</sup>	2,909	
PP&E		36,000
Deferred selling profit <sup>3</sup>		4,000

Notes:

1. Present value of the \$10,500 annual contractual lease payments and the \$9,200 guaranteed residual value, discounted at 4.29%.
2. Present value of the unguaranteed residual value (\$12,500 – \$9,200 guarantee), discounted at 4.29%.
3. Deferred selling profit = fair value of the underlying asset (\$40,000) less its carrying amount (\$36,000). This is the same as the difference between the lease receivable (\$37,091) and the carrying amount of the underlying asset, net of the unguaranteed residual value (\$33,091).

Because the lease is treated as a sale for income tax purposes, LR records the following journal entry to recognize the income tax effects of the lease on the commencement date.

	Debit	Credit
Current income tax expense (benefit) <sup>1</sup>	3,300	
Income taxes payable		3,300
Deferred tax asset <sup>2</sup>	1,200	
Deferred income tax expense (benefit)		1,200
Deferred tax liability <sup>3</sup>	2,100	
Deferred income tax expense (benefit)		2,100

Notes:

1. Tax gain of \$11,000 (\$40,000 tax sales price – \$29,000 tax carrying amount) × 30%.
2. Deferred profit of \$4,000 (\$40,000 fair value – \$36,000 book carrying amount) × 30%.
3. Previous book-tax basis difference of \$7,000 (\$36,000 book carrying amount – \$29,000 tax carrying amount) × 30% – i.e. a reduction of the previous deferred tax liability that existed because of the greater book carrying amount of the equipment compared to the tax basis in the equipment.

At the end of Year 1, LR records the following journal entry.

	<i>Debit</i>	<i>Credit</i>
Cash (lease payment received)	10,500	
Unguaranteed residual asset <sup>1</sup>	125	
Deferred profit <sup>2</sup>	1,637	
Lease receivable <sup>3</sup>		8,909
Interest income <sup>4</sup>		3,353

Notes:

1. Discount rate of  $4.29\% \times$  unguaranteed residual asset balance of \$2,909.
2. Total lease income of \$3,353 (calculated as the initial net investment in the lease of  $\$36,000 \times 9.31\%$ ) – interest on lease receivable (\$1,591 = 4.29% discount rate  $\times$  carrying amount of \$37,091) – accretion of unguaranteed residual asset (\$125 = 4.29% discount rate  $\times$  carrying amount of \$2,909).
3. 9.31% (rounded) is the discount rate that would have been required at lease commencement for the lease receivable plus the unguaranteed residual asset to equal the fair value of the underlying asset (\$40,000) less the deferred selling profit (\$4,000).
4. Total contractual payments of \$10,500 – interest on lease receivable of \$1,591.
5. Accretion of unguaranteed residual asset (\$125) plus interest income on lease receivable (\$1,591) + release of deferred profit (\$1,637).

At the end of Year 1, LR records the following journal entry to account for the tax effects of the lease.

	<i>Debit</i>	<i>Credit</i>
Current income tax expense (benefit) <sup>1</sup>	515	
Income tax payable		515
Deferred income tax expense (benefit) <sup>2</sup>	491	
Deferred tax asset		491

Notes:

1. \$40,000 tax basis in the financing  $\times 4.29\% = \$1,716 \times 30\%$ . This is also the 30% tax effect of Year 1 interest income on the lease receivable (\$1,591) and the unguaranteed residual asset (\$125). The interest on the deferred selling profit of \$1,637 is not factored in because there is no deferred selling profit for tax purposes.
2. Change in the deferred profit of  $\$1,637 \times 30\%$ .



## Observation

### Leveraged leases exception no longer required

10.1.200 Topic 740 includes an exception to its basic requirements related to leveraged leases. Topic 842 eliminates leveraged lease accounting prospectively – i.e. for all leases that commence on or after the effective date of Topic 842 (see section 13.6). Therefore, once Topic 842 becomes effective, and as the grandfathered leveraged leases gradually expire, this exception in

Topic 740 will no longer be relevant. The Board retained this exception in ASU 2016-02 because of its decision to grandfather existing leveraged leases.  
[740-10-25-3(c)]

## 10.1.5 Sale-leaseback considerations

10.1.210 As discussed in section 9.1, an entity entering into a sale-leaseback transaction will apply the specific requirements of Topic 606 (and other sale-leaseback specific considerations, such as whether the leaseback would be classified as a finance/sales-type lease) to determine whether the transfer of the asset is a sale.

10.1.220 If the transfer of the asset is considered a sale, the seller-lessee recognizes the transaction price for the sale (determined in accordance with Topic 606, adjusted for off-market terms) when the buyer-lessor obtains control of the asset, derecognizes the carrying amount of the sold asset and accounts for the lease in accordance with Topic 842.

10.1.230 Changes to the sale-leaseback guidance mean that many equipment sale-leaseback transactions accounted for as a sale and a leaseback under Topic 840 may be failed sales under Topic 842. This will create new deferred tax issues if the sale-leaseback transaction is accounted for as a sale and a leaseback for tax purposes. For example, while the seller-lessee may be considered to have sold the asset for tax purposes, it may still have the asset, as well as a financing liability, for book purposes.

10.1.240 If the form of the transaction is respected for tax purposes, a sale-leaseback transaction generally enables the seller-lessee to deduct the full rental payments that it makes to the buyer-lessor for tax purposes. In addition, the entity typically recognizes a gain or loss related to the sale of the asset. The gain may qualify as capital gains and the loss may be deductible in full as an ordinary loss for tax purposes depending on the specific situation. If the form of the transaction is not respected for tax purposes, a sale-leaseback is generally treated as a secured financing for tax purposes, in which case the seller-lessee is not treated as transferring tax ownership of the underlying asset and continues to take deductions for depreciation, as well as deductions for interest on financing provided by the buyer-lessor.

10.1.250 The buyer-lessor recognizes the asset at its purchase price (adjusted for off-market terms) and accounts for the lease in accordance with Topic 842. If the transfer of the asset is not deemed a sale (or purchase for the buyer-lessor), the seller-lessee does not derecognize the asset, continues to depreciate the asset and accounts for any amounts received as a financing liability. The buyer-lessor does not recognize the asset – i.e. the transaction results in a ‘failed purchase’ – and accounts for any amounts paid as a receivable in accordance with other Topics. This may result in new deferred tax issues if the sale-leaseback transaction is accounted for as a sale and a leaseback for tax purposes. The buyer-lessor might own the asset and be earning taxable lease income from the seller-lessee from the leaseback for tax purposes, but have a financing receivable and be earning interest income for book purposes.



### Example 10.1.40

#### **Sale-leaseback transaction accounted for as a sale and a leaseback for book purposes and for tax purposes (seller-lessee)**

Seller-Lessee SL sells a piece of land to unrelated Buyer-Lessor BL and at the same time reaches an agreement to lease the land back for 10 years. The following facts are relevant at the date of the transaction.

Contractual sales price:	\$3.5 million
Fair value of the land:	\$2.8 million
Carrying amount of the land:	\$2 million
Tax basis in the land:	\$2 million
Leaseback term:	10 years
Leaseback payments:	Fixed payments of \$200,000 per year (paid in arrears); no variable lease payments
Leaseback options:	None
Initial direct costs:	None
Rate implicit in the lease:	Not readily determinable
SL's incremental borrowing rate:	6%
SL's tax rate for ordinary income and capital gains:	30%

In addition:

- The transaction is accounted for as a sale and a leaseback (i.e. the transaction is not a failed sale) for both book and tax purposes.
- The leaseback is a true tax lease for tax purposes.

At the date that the sale is completed and the leaseback commences, SL recognizes the following journal entry for book purposes (excluding income tax effects).

	Debit	Credit
Cash (sales price of asset)	3,500,000	
Gain <sup>1</sup>	800,000	
Land	2,000,000	
Financing liability <sup>2</sup>	700,000	
ROU asset <sup>3</sup>	772,017	
Lease liability		772,017

## Notes:

1. \$2.8 million fair value – \$2 million carrying amount.
2. \$3.5 million sales price – \$2.8 million fair value.
3. Present value of 10 annual lease payments of \$104,892, discounted at 6%; \$104,892 = \$200,000 contractual leaseback payment – \$95,108 allocated to repayment of the \$700,000 financing liability.

For tax purposes, SL recognizes the \$1.5 million difference between the contractual sales price of \$3.5 million and the tax basis in the land of \$2 million as a gain on the sale of the land. In addition, because the leaseback is a true tax lease, SL does not have any lease asset or lease liability for tax purposes.

Consequently, at the date the sale is completed and the leaseback commences, SL recognizes the following income tax effects for book purposes.

	<i>Debit</i>	<i>Credit</i>
Current income tax expense (benefit) <sup>1</sup>	450,000	
Current tax payable		450,000
Deferred tax asset <sup>2</sup>	210,000	
Deferred income tax expense (benefit)		210,000
Deferred tax asset <sup>3</sup>	231,605	
Deferred income tax expense (benefit)		231,605
Deferred income tax expense (benefit) <sup>4</sup>	231,605	
Deferred tax liability		231,605

## Notes:

1. 30% tax effect on taxable gain of \$1.5 million (\$3.5 million contractual purchase price less \$2 million tax basis carrying amount).
2. \$700,000 carrying amount of the financing liability × 30%.
3. \$772,017 carrying amount of the lease liability × 30%.
4. \$772,017 carrying amount of the ROU asset × 30%.

During the first year of the leaseback, for book purposes, SL recognizes the following journal entry (excluding income tax effects).

	<i>Debit</i>	<i>Credit</i>
Interest expense <sup>1</sup>	42,000	
Operating lease cost <sup>2</sup>	104,892	
Lease liability <sup>3</sup>	58,571	
Financing liability <sup>4</sup>	53,108	
ROU asset <sup>5</sup>		58,571
Cash		200,000

## Notes:

1. 6% discount rate × \$700,000 financing liability.
2. Total lease payments of \$1,048,920 / 10-year lease term.

3. \$104,892 (portion of \$200,000 annual payment allocated to the lease) – \$46,321 accretion of the lease liability ( $\$772,017 \times 6\%$ ).
4. \$95,108 (portion of \$200,000 annual payment allocated to the financing liability) – \$42,000 interest on the financing liability ( $\$700,000 \times 6\%$ ).
5. Total lease cost of \$104,892 less accretion on lease liability of \$46,321.

During the first year of the leaseback, for tax purposes, SL deducts the \$200,000 rental payment from its taxable income and SL recognizes the following income tax effects for book purposes.

	<i>Debit</i>	<i>Credit</i>
Current tax payable <sup>1</sup>	60,000	
Current income tax expense (benefit)		60,000
Deferred tax liability <sup>2</sup>	17,571	
Deferred income tax expense (benefit)		17,571
Deferred income tax expense (benefit) <sup>3</sup>	17,571	
Deferred tax asset		17,571
Deferred income tax expense (benefit) <sup>4</sup>	15,932	
Deferred tax asset		15,932

Notes:

1. 30% tax effect of the \$200,000 contractual lease payment, fully deductible in the year paid.
2. 30% tax effect of the Year 1 change in the book carrying amount of the ROU asset of \$58,571.
3. 30% tax effect of the Year 1 change in the book carrying amount of the lease liability of \$58,571.
4. 30% tax effect of the Year 1 change in the book carrying amount of the financing liability of \$53,108.



### Example 10.1.50

#### Failed equipment sale-leaseback transaction for book purposes; sale and true tax leaseback for tax purposes

On January 1, 20X1, Seller-Lessee SL has a piece of equipment that it has decided to sell to Buyer-Lessor BL and lease back for liquidity purposes. The following facts are relevant at the date of the transaction.

Contractual sales price:	\$1 million
Fair value of the equipment:	\$1 million
Carrying amount of the equipment:	\$900,000
Tax basis in the equipment:	\$750,000
Leaseback term:	5 years

Remaining economic life of the equipment:	10 years, which is also the remaining useful life of the equipment
Expected future residual value:	\$450,000
Leaseback payments:	Fixed payments of \$170,000 per year (paid in arrears); no variable lease payments
Leaseback renewal or termination options:	None
Initial direct costs:	None
Rate implicit in the leaseback:	Not readily determinable by SL; 7.5381% for BL
SL's incremental borrowing rate:	7%
SL's tax rate for ordinary income and capital gains:	30%

The following additional facts are relevant.

- There is a fixed price repurchase option for SL to repurchase the equipment at any time during the fifth year of the leaseback; therefore, the transaction is a failed sale for book purposes.
- The transaction is a sale and a leaseback for tax purposes; the leaseback is a true tax lease for tax purposes.

### Scenario 1: Seller-lessee accounting

On January 1, 20X1, SL records the following journal entry to account for the failed sale (excluding income tax effects).

	Debit	Credit
Cash	1,000,000	
Financing liability		1,000,000

On January 1, 20X1, SL records the following journal entry to account for the sale-date income tax effects of the transaction.

	Debit	Credit
Current income tax expense (benefit) <sup>1</sup>	75,000	
Income taxes payable		75,000
Deferred tax liability <sup>2</sup>	45,000	
Deferred income tax expense (benefit)		45,000
Deferred income tax expense (benefit) <sup>3</sup>	270,000	
Deferred tax liability		270,000
Deferred tax asset <sup>4</sup>	300,000	
Deferred income tax expense (benefit)		300,000

## Notes:

1. 30% tax effect of sales price (\$1,000,000) – tax basis carrying amount (\$750,000).
2. Reversal of existing deferred tax liability (\$900,000 – \$750,000) × 30%.
3. 30% tax effect of the basis difference between the carrying amount of the equipment for book purposes (\$900,000) and the tax basis (nil).
4. 30% tax effect of the financing liability (\$1,000,000), which has no tax basis.

On December 31, 20X1, SL records the following journal entry to record the payment made to BL under the terms of the sale-leaseback agreement, and depreciation on the equipment that continues to be recognized by SL due to the failed sale (excluding income tax effects).

	Debit	Credit
Interest expense <sup>1</sup>	70,000	
Financing liability <sup>2</sup>	100,000	
Cash		170,000
Depreciation expense <sup>3</sup>	90,000	
Accumulated depreciation		90,000

## Notes:

1. \$1,000,000 principal balance × 7% (SL's incremental borrowing rate).
2. Payment of \$170,000 – interest component of \$70,000.
3. \$900,000 book carrying amount at beginning of the year / 10 years.

Also on December 31, 20X1, SL records the following journal entry for the income tax effects of the first year of the arrangement.

	Debit	Credit
Income taxes payable <sup>1</sup>	51,000	
Current income tax expense (benefit) <sup>1</sup>		51,000
Deferred tax liability <sup>2</sup>	27,000	
Deferred income tax expense (benefit) <sup>2</sup>		27,000
Deferred income tax expense (benefit) <sup>3</sup>	30,000	
Deferred tax asset <sup>3</sup>		30,000

## Notes:

1. 20X1 lease payment for tax purposes of \$170,000 × 30%, which is fully deductible in the year paid.
2. 30% of the change in the book carrying amount of the equipment, which decreased from \$900,000 to \$810,000 as a result of depreciation (\$90,000) during the year.
3. 30% of the change in the book carrying amount of the financing liability, which decreased from \$1,000,000 to \$900,000 during the year.

**Scenario 2: Buyer-lessor accounting**

On January 1, 20X1, BL records the following journal entry to account for the failed sale (excluding income tax effects).

	<i>Debit</i>	<i>Credit</i>
Financing receivable	1,000,000	
Cash		1,000,000

On January 1, 20X1, SL records the following journal entry to account for the sale-date income tax effects of the transaction.

	<i>Debit</i>	<i>Credit</i>
Deferred tax asset <sup>1</sup>	300,000	
Deferred income tax expense (benefit)		300,000
Deferred income tax expense (benefit) <sup>2</sup>	300,000	
Deferred tax liability		300,000

Notes:

1. 30% tax effect of \$1,000,000 of equipment recognized as an asset for tax purposes, but not recognized for book purposes (failed purchase).
2. 30% tax effect of the financing receivable recognized for book purposes, but not for tax purposes.

On December 31, 20X1, BL records the following journal entry to record the payment from SL under the terms of the sale-leaseback agreement (excluding income tax effects).

	<i>Debit</i>	<i>Credit</i>
Cash	170,000	
Interest income <sup>1</sup>		60,000
Financing receivable <sup>2</sup>		110,000

Notes:

1. \$1,000,000 principal balance × 6%. Consistent with Example 2 in Subtopic 842-40, BL determined this rate of interest based on the guidance in Subtopic 835-30 (imputation of interest).
2. Payment of \$170,000 – interest component of \$60,000.

On December 31, 20X1, BL records the following journal entry to account for the first year income tax effects of the arrangement.

	<i>Debit</i>	<i>Credit</i>
Deferred income tax expense (benefit) <sup>1</sup>	60,000	
Deferred tax asset <sup>1</sup>		60,000
Deferred tax liability <sup>2</sup>	33,000	
Deferred income tax expense (benefit) <sup>2</sup>		33,000
Income tax payable <sup>3</sup>	9,000	
Current income tax expense (benefit) <sup>3</sup>		9,000

## Notes:

1. 30% tax effect of decrease in the tax basis of the equipment resulting from MACRS depreciation. MACRS depreciation for the year ended December 31, 20X9 is \$200,000.
2. 30% tax effect of the change in the book carrying amount of the financing receivable ( $30\% \times \$110,000$ ).
3. 30% tax effect of the true tax lease income of \$170,000 earned in the first year of the leaseback – 30% tax effect of MACRS tax depreciation of equipment of \$200,000.



### Question 10.1.20

#### Impact of foreign currency

#### What are the deferred tax consequences of a lease being denominated in a foreign currency?

**Interpretive response:** For leases denominated in a foreign currency, the ROU asset is a nonmonetary asset while the lease liability is a monetary liability. Therefore, when accounting for a lease that is denominated in a foreign currency, the lease liability is remeasured using the current exchange rate, while the ROU asset is remeasured using the exchange rate as of the lease commencement date (see section 6.4.3). As a result, the exception on recognizing a deferred tax asset or liability for differences related to assets and liabilities that are remeasured from the local currency into the functional currency using historical exchange rates and that result from changes in exchange rates will apply to the ROU asset but will not apply to the lease liability under Topic 842. [842-20-55-10, 740-10-25-3(f)]

## 10.2 State and local income tax implications

10.2.10 Although domestic tax laws may remain unchanged on the adoption of Topic 842, and most states that use a property factor already include the value of leased assets in the apportionment formula, the requirement to bring all leases (other than those qualifying for the short-term exemption – see section 6.3.1) on the balance sheet may affect the apportionment of taxable income in some states. Entities should consider the need to review both state and local income tax laws to determine the effect of Topic 842, if any.

10.2.20 An entity will need to consider the effect of any changes, if applicable, on its state apportionment factors in its assessment of any necessary valuation allowance. Most states that use a property factor already require leased assets to be included in the factor and provide a valuation method for including such assets. In general, the Uniform Division of Income for Tax Purposes Act, which has been widely adopted by the states, provides that property rented by the taxpayer is valued at eight times the net annual rental rate. Nevertheless, the effect of including leases on the balance sheet may change the apportionment of taxable income in some states.

10.2.30 For measuring state deferred tax assets and liabilities, an entity should assume that temporary differences will reverse in the tax jurisdictions in which the related assets or liabilities are expected to be realized or settled, and therefore would apply the enacted tax rate for that particular state for measuring deferred taxes. Entities generally should not assume that taxable or deductible amounts related to temporary differences in a tax jurisdiction will be shifted to a different tax jurisdiction through future intercompany transactions.

## 10.3 Change in US Federal Tax Accounting Method

10.3.10 Generally, a change in book accounting method (e.g. in accounting for leases) will not be deemed to constitute a change in underlying facts for US federal tax procedural purposes. If a new tax accounting method is required or desirable because the book accounting method changes, an entity must obtain permission from the IRS in advance of the change. The filing procedures and timing vary based on whether the change is automatic or requires advance consent from the IRS.

10.3.20 An entity that changes to a tax accounting method identified in published IRS guidance (currently Rev. Proc. 2015-14) is deemed to be automatically approved by the IRS when the copy of Form 3115, Application for Change in Accounting Method, is filed and, at the same time, generally receives audit protection for prior years. For book purposes, the timing of recognizing the effects of a change in tax accounting methods will depend on when the entity determines to make the change, when Form 3115 is filed, and whether the entity is changing from an impermissible method to a permissible method.

10.3.30 When a tax accounting method change is outside the automatic procedures, IRS approval of the change is not automatic. The entity will need to consider the requirements of Topic 740 on accounting for tax positions with uncertainty to determine whether it is appropriate to account for the change before it receives approval (i.e. the consent letter).

10.3.40 The adoption of Topic 842 may result in a change in the pattern of recognizing income and expenses for financial reporting purposes for an entity. An entity should consider whether a tax accounting method change is appropriate and the related tax adjustment. An unfavorable adjustment (i.e. the income inclusion catch-up adjustment that is the difference between the tax accounting on the old method and new method as of the beginning of the year of change) would generally be spread over four years for US federal tax purposes. This would also create an additional temporary difference for the portion of the effect of the tax accounting method change that has not yet been recognized for tax purposes.

## 10.4 Transfer pricing

10.4.10 The classification of leases may affect both the lessee and lessor from a transfer pricing perspective. Changes to the amount and timing of lease income and lease expense as a result of adopting Topic 842 could have an effect on

transfer pricing, specifically as it relates to using revenue or profit-based methods for establishing the transfer pricing.

10.4.20 Entities use transfer pricing to determine the appropriate amount to charge for intercompany transactions. Intercompany transactions are eliminated from the consolidated results for book purposes, but are not eliminated in each taxing jurisdiction for tax purposes. As a result, an entity uses transfer pricing to help determine each member of the group's taxable income.

10.4.30 While each taxing authority has different rules and thresholds, the transactions must usually be priced at arm's-length. Under the arm's-length standard, governments evaluate whether intercompany transactions are priced similar to arm's length transactions. Arm's-length transactions help ensure that an entity is not inappropriately allocating income to any particular tax jurisdiction.

10.4.40 Entities may lease assets to one another for various reasons. If a lease is obtained from a related party, the interest rate and related terms generally should be the same (or within a reasonable range) compared to what it would receive from an unrelated party in an arm's-length transaction. For a true tax lease, an entity will need to determine that the rental rates are appropriate and are considered to be at arm's length. Entities should carefully consider the classification of the leases from both a lessor and lessee perspective.

10.4.50 An entity may need to consider whether its transfer pricing studies and supporting documentation should be revised or updated once the standard has been adopted.

# 11. Leases acquired in a business combination or asset acquisition

## Detailed contents

### How the standard works

#### 11.1 Accounting for leases acquired in a business combination

- 11.1.1 Lease identification
- 11.1.2 Lease classification
- 11.1.3 Acquisition date recognition and measurement
- 11.1.4 Leveraged leases
- 11.1.5 Post-acquisition accounting

### Observation

Measurement of lease assets and lease liabilities is not at fair value

### Questions

- 11.1.10 Reassessment of lease identification
- 11.1.20 Acquiree assessment of lease classification or lease identification is not known
- 11.1.25 Reassessment of lease identification – acquiree's assessment not made under US GAAP
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- 11.1.40 Different acquirer and acquiree transition elections
- 11.1.50 Reassessment of lease identification – only the acquirer has adopted Topic 842
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- 11.1.95 Reassessment of lease classification – acquiree's assessment not made under US GAAP
- 11.1.100 Incremental borrowing rate to use when measuring an acquired lease – implicit rate not readily determinable
- 11.1.110 In-place leases
- 11.1.120 Subleases of an acquiree
- 11.1.130 Preexisting lease relationship
- 11.1.140 Favorability or unfavorability associated with a renewal option
- 11.1.150 Lease classification impact on the measurement of underlying assets
- 11.1.160 How off-market lease terms affect the fair value of the underlying asset in sales-type and direct financing leases – lessors
- 11.1.170 Involvement of a third-party lessor in a business combination
- 11.1.180 Acquisition accounting for an acquiree failed sale/purchase
- 11.1.190 Accounting for leases acquired in an asset acquisition
- 11.1.200 Different acquirer/acquiree separation of lease and non-lease component policy elections
- 11.1.210 Measurement of acquired related party leases with off-market terms
- 11.1.220 Acquirer accounting for an operating lease when it is the lessee and is reasonably certain to exercise a lessee purchase option
- 11.1.230 (Un)favorable contract (liabilities) assets for contracts not accounted for as leases before a modification

### **Examples**

- 11.1.10 Reassessing lease identification
- 11.1.20 Accounting for an acquired lease (operating lease)
- 11.1.30 Accounting for an acquired lease (finance/sales-type lease)
- 11.1.40 Accounting for an acquired lease (operating lease) when the acquirer is reasonably certain to exercise a lessee purchase option

### **Comparison to legacy US GAAP**

## How the standard works

In summary, the following are recognized as part of the acquisition accounting.

Acquiree is lessee:	Acquiree is lessor:	
Operating or finance lease	Operating lease	Sales-type or direct financing lease
<ul style="list-style-type: none"> <li>— ROU asset</li> <li>— Lease liability</li> </ul>	<ul style="list-style-type: none"> <li>— Property, plant and equipment</li> <li>— Asset or liability (off-market lease terms)</li> </ul>	<ul style="list-style-type: none"> <li>— Lease receivable</li> <li>— Unguaranteed residual asset<sup>1</sup></li> </ul>
<ul style="list-style-type: none"> <li>— In all cases, any related intangible assets (e.g. a customer relationship) are recognized.</li> <li>— The acquirer retains the acquiree's lease classification unless the lease is modified as part of the acquisition, and that modification is not accounted for as a separate contract under Topic 842 (see Question 11.1.60).</li> <li>— In all cases, the lease assets and lease liabilities are measured as if the lease were a new lease of the acquirer at the acquisition date.</li> </ul>		

Note:

1. The lease receivable and the unguaranteed residual asset are presented together as a single net investment in the lease (see section 7.3.1).

Topic 842 includes only limited guidance on accounting for leases acquired in a business combination. Most of the guidance on this topic, including more detailed guidance on the initial and subsequent measurement of assets and liabilities related to lease contracts acquired in a business combination, is included in Topic 805 (business combinations), which was amended by ASU 2016-02.

## 11.1 Accounting for leases acquired in a business combination



### Excerpt from ASC 842-10

#### 15 Scope and Scope Exceptions

##### General

> Identifying a Lease

**15-2** At inception of a **contract**, an entity shall determine whether that contract is or contains a **lease**.

**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.

#### 55 Implementation guidance and illustrations

##### General

> Implementation Guidance

- > Lease Classification

- • > Lease of an Acquiree

**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.



### Excerpt from ASC 842-20

#### 35 Subsequent Measurement

##### General

> Amortization of Leasehold Improvements

**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.



### Excerpt from ASC 805-20

#### 25 Recognition

- > Classifying or Designating Identifiable Assets Acquired and Liabilities Assumed in a Business Combination

**25-6** At the acquisition date, the acquirer shall classify or designate the identifiable assets acquired and liabilities assumed as necessary to subsequently apply other GAAP. The acquirer shall make those classifications or designations on the basis of the contractual terms, economic conditions, its operating or accounting policies, and other pertinent conditions as they exist at the acquisition date.

**25-8** This Section provides the following two exceptions to the principle in paragraph 805-20-25-6:

- a. Classification of a lease of an acquiree shall be in accordance with the guidance in paragraph 842-10-55-11
- b. Classification of a contract written by an entity that is in the scope of Subtopic 944-10 as an insurance or reinsurance contract or a deposit contract. The acquirer shall classify that contract on the basis of the contractual terms and other factors at the inception of the contract (or, if the terms of the contract have been modified in a manner that would change its classification, at the date of that modification, which might be the acquisition date).

> Recognizing Particular Assets Acquired and Liabilities Assumed

**25-9** Guidance on recognizing identifiable intangible assets, including operating leases and reacquired rights, follows.

- > Identifiable Intangible Assets

**25-10** The acquirer shall recognize separately from goodwill the identifiable intangible assets acquired in a business combination. An intangible asset is identifiable if it meets either the separability criterion or the contractual-legal criterion described in the definition of identifiable. Additional guidance on applying that definition is provided in paragraphs 805-20-25-14 through 25-15, 805-20-55-2 through 55-45, and Example 1 (see paragraph 805-20-55-52). For guidance on the recognition and subsequent measurement of a defensive intangible asset, see Subtopic 350-30.

**25-10A** An identifiable intangible asset may be associated with a lease, which may be evidenced by market participants' willingness to pay a price for the lease even if it is at market terms. For example, a lease of gates at an airport or of retail space in a prime shopping area might provide entry into a market or other future economic benefits that qualify as identifiable intangible assets, such as a customer relationship. In that situation, the acquirer shall recognize the associated identifiable intangible asset(s) in accordance with paragraph 805-20-25-10.

- > Operating Leases

**25-11** The acquirer shall recognize assets or liabilities related to an operating lease in which the acquiree is the lessee as required by paragraphs 805-20-25-10A and 805-20-25-28A.

**25-12** Regardless of whether the acquiree is the lessee or the lessor, the acquirer shall determine whether the terms of each of an acquiree's operating leases are favorable or unfavorable compared with the market terms of leases of the same or similar items at the acquisition date. If the acquiree is a lessor, the acquirer shall recognize an intangible asset if the terms of an operating lease are favorable relative to market terms and a liability if the terms are

unfavorable relative to market terms. If the acquiree is a lessee, the acquirer shall adjust the measurement of the acquired right-of-use asset for any favorable or unfavorable terms in accordance with paragraph 805-20-30-24.

**25-13** An identifiable intangible asset may be associated with an operating lease, which may be evidenced by market participants' willingness to pay a price for the lease even if it is at market terms. For example, a lease of gates at an airport or of retail space in a prime shopping area might provide entry into a market or other future economic benefits that qualify as identifiable intangible assets, such as a customer relationship. In that situation, the acquirer shall recognize the associated identifiable intangible asset(s) in accordance with paragraph 805-20-25-10.

> Exceptions to the Recognition Principle

- > Leases

**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.

### **30 Initial Measurement**

#### **General**

> Measurement Principle

**30-1** The acquirer shall measure the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at their acquisition-date fair values.

**30-2** Exceptions to the measurement principle are identified and their accounting treatment is addressed in paragraphs 805-20-30-10 through 30-23.

> Exceptions to the Measurement Principle

- > Measurement of Lease Assets and Lease Liabilities Arising from Leases in Which the Acquiree Is the Lessee

**30-24** For leases in which the acquiree is a lessee, the acquirer shall measure the lease liability at the present value of the remaining lease payments, as if the acquired lease were a new lease of the acquirer at the acquisition date. The acquirer shall measure the right-of-use asset at the same amount as the lease liability as adjusted to reflect favorable or unfavorable terms of the lease when compared with market terms.

- > Measurement of Assets and Liabilities Arising from Leases in Which the Acquiree Is the Lessor

**30-25** For leases in which the acquiree is a lessor of a sales-type lease or a direct financing lease, the acquirer shall measure its net investment in the

lease as the sum of both of the following (which will equal the fair value of the underlying asset at the acquisition date):

- a. The lease receivable at the present value, discounted using the rate implicit in the lease, of the following, as if the acquired lease were a new lease at the acquisition date:
  1. The remaining lease payments
  2. The amount the lessor expects to derive from the underlying asset following the end of the lease term that is guaranteed by the lessee or any other third party unrelated to the lessor.
- b. The unguaranteed residual asset as the difference between the fair value of the underlying asset at the acquisition date and the carrying amount of the lease receivable, as determined in accordance with (a), at that date.

The acquirer shall take into account the terms and conditions of the lease in calculating the acquisition-date fair value of an underlying asset that is subject to a sales-type lease or a direct financing lease by the acquiree-lessor.

### **35 Subsequent Measurement**

#### **General**

> Additional Guidance on Subsequent Measurement of Assets Acquired, Liabilities Assumed or Incurred, and Any Noncontrolling Interests in a Business Combination

**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

11.1.10 The following chart summarizes the acquirer's initial accounting at the acquisition date. The chart highlights the following. [805-20-25-10A, 25-12, 25-28A, 30-24 – 30-25]

- If the acquiree is a lessee, the same assets and liabilities are recognized regardless of whether the lease is an operating lease or a finance lease.
- If the acquiree is a lessor, the assets and liabilities recognized depend on whether the lease is an operating lease, or a sales-type or direct financing lease.
- In all cases, there may be one or more intangible assets related to the lease, such as a customer relationship, that must be recognized.

Lease acquired in a business combination <sup>1</sup>			
Acquiree is lessee		Acquiree is lessor	
Operating and finance leases		Operating leases	Sales-type and direct financing leases
<b>Lease liability<sup>2</sup></b> Present value of the remaining lease payments <sup>3</sup>	<b>ROU asset</b> Equal to the liability, adjusted for any favorable/unfavorable terms <sup>4</sup>	<b>PP&amp;E</b> Underlying asset at fair value	<b>Lease receivable</b> Present value of the remaining lease payments and guaranteed residual value <sup>5</sup>
<b>Intangible assets</b> Associated with the lease <sup>8</sup>			<b>Asset or liability</b> Favorable/unfavorable terms <sup>6</sup>
			<b>Unguaranteed residual asset</b> Difference between fair value of underlying asset <sup>7</sup> and lease receivable
			<b>Intangible assets</b> Associated with the lease <sup>8</sup>

Notes:

1. The acquirer retains the acquiree's lease classification unless the lease is modified as part of the business combination, and that modification is not accounted for as a separate contract (see Question 11.1.60). [805-20-25-8, 842-10-55-11]
2. The lease liability (lessee) or lease receivable (lessor in a sales-type or direct financing lease) is measured as if the lease were a new lease at that date – i.e. as if the acquisition date were the lease commencement date. [805-20-30-24, 30-25(a)]
3. Discounted at the rate implicit in the lease if readily determinable, or otherwise using the acquirer's incremental borrowing rate (see Question 11.1.100). [805-20-30-24]
4. Renewal and/or purchase options that are either (1) favorable to the acquiree-lessee or (2) unfavorable to the acquiree-lessee but for which exercise is outside of the control of the acquiree-lessee (e.g. within the control of the lessor or an unrelated third party) affect the measurement of the ROU asset (see Question 11.1.140).
5. Discounted at the rate implicit in the lease. [805-20-30-25]
6. If a renewal option or a purchase option is unfavorable to the acquiree-lessor, a liability is recognized if exercise of the option is outside the lessor's control (see Question 11.1.140).
7. The terms and conditions of the lease are taken into account in determining the fair value of the underlying asset in a sales-type or direct financing lease (see Questions 11.1.150 and 11.1.160).
8. Even if a lease is at market terms, there may be other identifiable intangible assets associated with the lease, such as an in-place lease asset (see Question 11.1.110) or a customer relationship. For example, a lease of gates at an airport or of retail space in a prime shopping area might provide entry into a market or other future economic benefits that qualify as an identifiable intangible asset. Such identifiable intangible assets are recognized at fair value in the acquisition accounting. [805-20-25-10A]

## 11.1.1 Lease identification

11.1.20 Both parties to a contract (the customer and the supplier) evaluate at *inception* of the contract whether it is or contains a lease. An entity does not

reassess whether a contract is or contains a lease unless the terms and conditions of the contract are changed. [842-10-15-2, 15-6 – 15-7]

## Question 11.1.10

### Reassessment of lease identification

#### When should an acquirer reassess lease identification in a business combination?

**Background:** Topic 842 provides specific guidance about when to reassess the classification of a lease acquired in a business combination (see paragraph 11.1.10 (Note 1) and Question 11.1.60), while Question 11.1.90 provides our view about when Topic 842 requires an acquirer to reassess the classification of a lease acquired in an asset acquisition.

US GAAP does not provide explicit guidance about when, if ever, an acquirer should reassess an acquiree's conclusions about whether contracts acquired in a business combination are or contain a lease.

If reassessed as of the acquisition date, changed facts and circumstances since the acquiree's assessment could lead to different conclusions about whether a contract is or contains a lease. For example, changes in technology or other factors since the acquiree's assessment date could affect whether a substantive substitution right exists for the remainder of the 'period of use' from the acquisition date.

In addition, even if reassessed by the acquirer as of the acquiree's assessment date, different facts and circumstances and/or different judgments may have led to a different lease identification conclusion. For example, because of its operations or other circumstances different from the acquiree, the acquirer might have concluded that it could economically benefit from a substitution right that the acquiree concluded it could not benefit from.

**Interpretive response:** We believe an acquirer should reassess the acquiree's lease identification conclusions only for acquired contracts whose terms and conditions are changed in connection with the transaction. [842-10-15-6]

If lease identification is reassessed because of changed contractual terms and conditions, it is reassessed as of the acquisition date based on the changed terms and conditions of the contract.

#### Asset acquisitions

We believe the above applies equally to leases acquired in an asset acquisition.

#### Acquiree assessments made in error

This interpretive response presumes that the acquiree's lease identification conclusions were appropriate. Topic 842 and Topic 805 do not grandfather accounting conclusions reached in error; therefore, an acquirer is required to consider whether the acquiree's lease identification assessments were appropriate.

If a reassessment is required because of an acquiree error only, that reassessment is undertaken based on the acquiree's business and the facts and circumstances as of the date the acquiree should have undertaken the assessment – i.e. the acquirer's objective is solely to correct the acquiree's error.



### Question 11.1.20

#### **Acquiree assessment of lease classification or lease identification is not known**

#### **What should an entity do if it does not know the acquiree's lease classification or lease identification assessment?**

**Background:** Acquirers in a business combination (or asset acquisition) will frequently not reassess the acquiree's classification of a lease (see section 11.1.2) or its conclusions about lease identification (see Question 11.1.10).

The pre-acquisition lease classification or lease identification assessment may not be known by the acquirer, particularly in asset acquisitions. Therefore, the question arises about how the acquirer should determine the pre-acquisition lease classification or lease identification assessment.

**Interpretive response:** We believe it is necessary for the acquirer to assess the pre-acquisition lease classification or lease identification *as if it was the acquiree* – i.e. to determine what the acquiree's classification or lease identification assessment should have been, based on the acquiree's business and the facts and circumstances as of the date the acquiree should have undertaken that assessment.

Paragraphs 842-10-55-11, 842-10-25-1 and 842-10-15-6, which we reference in our responses to Questions 11.1.60, 11.1.90 and 11.1.10, do not include practicability or other similar exceptions. Therefore, we do not believe an acquirer can avoid using the pre-acquisition lease classification or lease identification assessment on the basis that either it does not know the pre-acquisition assessments or that one or more of them would be difficult to recreate.

To some extent, evaluating the pre-acquisition lease classification and lease identification assessments is required in all business combinations (and asset acquisitions) because the guidance grandfathering pre-acquisition assessments does not grandfather assessments reached in error. Therefore, acquirers will have to evaluate whether the pre-acquisition assessments were appropriate.

#### **Legacy US GAAP**

This situation also arose under legacy US GAAP (Topic 840), including under Topic 805 before the new definition of a business in ASU 2017-01 was adopted, albeit with lesser practical effect due to the off-balance sheet nature of operating leases for lessees. In those cases, we believe it was necessary for the acquirer to effectively recreate the pre-acquisition lease classification and/or lease identification assessment.



### Question 11.1.25

#### **Reassessment of lease identification – acquiree's assessment not made under US GAAP**

#### **Should the acquirer reassess the acquiree's lease identification conclusions if they were not reached under US GAAP?**

**Background:** Question 11.1.10 addresses when an acquirer should reassess lease identification in a business combination or an asset acquisition. That question assumes both the acquirer and the acquiree are US GAAP reporting entities.

This question addresses whether that same conclusion applies if the acquiree made its lease identification assessment under other GAAP (e.g. IFRS Accounting Standards or GASB standards).

**Interpretive response:** Yes. When an acquiree's accounting pre-acquisition is not under US GAAP, the acquirer must convert it to US GAAP. Regardless of whether the transaction is a business combination or an asset acquisition, this includes reassessing whether acquired contracts contain a lease using the Topic 842 definition of a lease.

When this occurs, the acquirer will need to determine what the acquiree's lease identification assessment would have been under Topic 842 based on the acquiree's business and the facts and circumstances as of the date the acquiree would have undertaken that assessment had it adopted Topic 842 at the same date as the acquirer.



### Question 11.1.30

#### **Reassessment of lease identification – acquirer and acquiree adopted Topic 842 at different dates**

#### **If the acquiree's lease identification conclusion was reached under Topic 840, does the acquirer need to reassess that conclusion in a business combination or an asset acquisition?**

**Background:** An acquirer and an acquiree may have adopted Topic 842 on different dates. For example, the acquirer adopted Topic 842 on January 1, 20X1 and the acquiree on July 1, 20X1, while the business combination or asset acquisition occurs on October 1, 20X1.

In Question 11.1.10, we discuss our view that an acquirer should *not* reassess the acquiree's lease identification conclusions in a business combination or asset acquisition unless the terms and conditions of the contract are changed in connection with the transaction.

However, because of the different acquirer and acquiree adoption dates, the question arises about whether acquiree contracts that would have been assessed for lease identification under Topic 842 had the acquiree adopted

Topic 842 on the same date as the acquirer need to be reassessed for lease identification under Topic 842. In this background example, the question would apply to contracts entered into or modified from January 1, 20X1 through June 30, 20X1 (assuming the acquirer elected the transition package of practical expedients).

**Interpretive response:** We are aware of multiple views about this question. In the absence of additional guidance from the FASB or the SEC staff, we believe the following views are acceptable.

**View 1: Do not reassess any contracts for which the terms and conditions are not changed in connection with the transaction**

Under this view, the different adoption dates for the acquirer and the acquiree are ignored when considering which contracts, if any, to reassess for lease identification. Consistent with our non-transition related response to Question 11.1.10, the acquirer reassesses lease identification for existing acquiree contracts only if the terms and conditions of the contract are changed in connection with the transaction (assuming the acquiree's lease identification conclusions were not reached in error).

The basis for this view is that there is no requirement for the acquirer to conform the two parties' validly elected adoption dates as part of its acquisition accounting. Therefore, the requirement to reassess lease identification should not differ from that outlined in Question 11.1.10 solely because of different Topic 842 adoption dates. By contrast, View 2 in effect treats adoption dates of a new accounting standard (in this case, Topic 842) as an accounting policy that must be conformed.

**View 2: Reassess those contracts that would have been assessed by the acquirer under Topic 842, but were assessed by the acquiree under Topic 840**

Under this view, the acquirer reassesses any contracts assessed for lease identification by the acquiree using the Topic 840 definition of a lease that would have been assessed by the acquiree using the Topic 842 definition of a lease if it had adopted Topic 842 on the same date as the acquirer. That reassessment is undertaken based on the acquiree's business and the facts and circumstances as of the date the acquiree should have undertaken it.

Using the background example, because the acquirer adopted Topic 842 on January 1, 20X1 applying the transition package of practical expedients, any contracts it entered into or modified (and the modification not accounted for as a separate contract) on or after January 1, 20X1 would have been assessed by the acquirer for lease identification using the Topic 842 definition of a lease. Those same contracts, if entered into or modified before the acquiree's July 1, 20X1 adoption date, and assuming the acquiree also elected the transition package of practical expedients, were assessed for lease identification by the acquiree using the Topic 840 definition of a lease.

Under View 2, assuming none of those contracts were reassessed by the acquiree on or after its own adoption date (e.g. because of a modification not accounted for as a separate contract), the acquirer reassesses whether they are or contain leases consistent with the preceding paragraphs.

The parties' transition elections affect how this view is applied.

- If the acquiree did not elect the transition package of practical expedients, regardless of the acquirer's transition package election, the acquirer does not reassess any of the acquiree's existing contracts. This is because they all would have been assessed (or reassessed) by the acquiree under the Topic 842 definition of a lease when it adopted Topic 842.<sup>1</sup>
- If only the acquiree elected the transition package of practical expedients, the acquirer follows one of the following approaches.
  - *If the acquirer does not treat the acquiree's transition elections as accounting policies to conform (see Question 11.1.40)*, the acquirer reassesses those acquiree contracts that would have been assessed by the acquiree using the Topic 842 lease definition if it had adopted the standard on the acquirer's adoption date. These are the same contracts that would be reassessed if *both* parties had elected the package of practical expedients.
  - *If the acquirer treats the acquiree's transition elections as accounting policies to conform (see Question 11.1.40)*, the acquirer reassesses all of the acquiree's existing contracts entered into or last modified before the acquiree's adoption date, including those entered into or last modified before the acquirer's adoption date.

Which party, the acquirer or the acquiree, adopted Topic 842 first can also affect how this view is applied. Instead of the example presented, assume that the acquiree adopted Topic 842 before the acquirer.

- If both parties, neither party or only the acquirer elected the transition package of practical expedients, the acquirer does not reassess any of the acquiree's existing contracts.<sup>1</sup>
- If only the acquiree elected the transition package of practical expedients, the acquirer follows one of the following approaches.
  - *If the acquirer does not treat the acquiree's transition elections as accounting policies to conform (see Question 11.1.40)*, the acquirer does not reassess any of the acquiree's existing contracts.<sup>1</sup>
  - *If the acquirer treats the acquiree's transition elections as accounting policies to conform (see Question 11.1.40)*, the acquirer reassesses any acquired contracts not assessed by the acquiree under the Topic 842 definition of a lease.<sup>1</sup> This would be any contracts entered into or modified (and not meeting the Topic 842 criteria to be accounted for as a separate contract) before the acquiree's Topic 842 adoption date.

Note:

1. All contracts for which the terms and conditions are changed in connection with the business combination (or asset acquisition), or for which the acquiree's assessment is reached in error, must be reassessed. See Question 11.1.10.



### Question 11.1.40

#### Different acquirer and acquiree transition elections

### Should an acquirer conform the acquiree's transition elections to its own in its business combination accounting?

**Background:** Assume an acquirer and acquiree made different transition elections when adopting Topic 842. For example, the acquiree elected the transition package of practical expedients and the land easement practical expedient (see section 13A.2 or section 13B.2), while the acquirer did not elect either.

Consequently, the acquiree has:

- leases classified as operating leases that would have been classified as finance (lessee) or sales-type (lessor) leases had they been reassessed under Topic 842;
- contracts accounted for as leases that would not have met the Topic 842 definition of a lease, and vice versa; and
- land easements not accounted for as leases that would have met the definition of a lease under Topic 842.

In this example, is the acquirer required to reassess:

- what the lease classification of the acquiree *would have been* had the acquiree not elected the transition package of practical expedients to classify the acquired leases post-acquisition?
- whether contracts acquired from the acquiree would have met the Topic 842 definition of a lease if they had been reassessed on adoption by the acquiree?
- whether land easements acquired from the acquiree would have met the Topic 842 definition of a lease if assessed as part of the acquiree's adoption?

**Interpretive response:** No. Accounting policies applicable to assets acquired and liabilities assumed from an acquiree generally should be conformed to those of the acquirer after a business combination (see chapter 7 of KPMG Handbook, [Business combinations](#)). However, we believe this applies only to ongoing accounting policies, and that an acquiree's valid, one-time transition elections when adopting Topic 842 are not accounting policies of the acquiree that must be conformed to those of the acquirer.

Unless the related contracts are modified in connection with the business combination (and the modification is not accounted for as a separate contract) or the acquiree's conclusions were reached in error, in the background example this means the acquirer retains:

- the acquiree's lease classification for identified leases; and
- the acquiree's lease identification conclusions, including those for its land easements.

Notwithstanding this interpretive response, we do not believe there is guidance in Topic 842, Topic 805 or elsewhere in US GAAP that would *prohibit* an acquirer from treating the acquiree's transition elections as accounting policies

to conform to its own. An acquirer's decision in this regard should be applied consistently.



### Question 11.1.50

#### **Reassessment of lease identification – only the acquirer has adopted Topic 842**

#### **Does the acquirer need to reassess the acquiree's contracts for lease identification if the acquirer has adopted Topic 842 before the acquisition date, but the acquiree has not?**

**Background:** Assume an acquirer adopted Topic 842 on January 1, 20X1, while the acquiree had not yet adopted Topic 842 on the October 1, 20X1 business combination date – e.g. because the acquiree was a private company.

Therefore, all of the acquiree's pre-acquisition lease identification conclusions were reached under Topic 840, which may differ from those that would have been reached under Topic 842.

The question arises about whether the acquirer must reassess the acquiree's lease identification conclusions based on the Topic 842 definition of a lease.

**Interpretive response:** We believe that the extent to which the acquirer needs to reassess the acquiree's Topic 840 lease identification conclusions (assuming neither of the circumstances in Question 11.1.10 – changed terms and conditions or acquiree error – are present) depends on whether the acquiree early adopts Topic 842 before the acquisition occurs.

#### **Acquiree does not early adopt Topic 842**

If the acquiree does not early adopt Topic 842 before the acquisition occurs, we believe the acquiree's accounting under Topic 840 is akin to a situation where the acquiree's accounting is under IFRS Accounting Standards or other GAAP that is not US GAAP (see Question 11.1.25).

Therefore, under this view, which treats Topic 840 as akin to IFRS Accounting Standards or other local GAAP, the acquirer reassesses all of the acquiree's contracts for lease identification using the Topic 842 definition of a lease as of the date that the acquiree would have undertaken that assessment had it adopted Topic 842 at the same date as the acquirer.

#### **Acquiree early adopts Topic 842**

Topic 842 permits early adoption (see sections 13A.1 and 13B.1). Therefore, the acquiree could have early adopted Topic 842 immediately before the acquisition closes, *with retrospective effect to the beginning of its current fiscal year*.

Using the acquiree in the background example, and assuming the acquiree has a calendar fiscal year, it could have early adopted Topic 842 immediately before the acquisition closes on October 1, 20X1, effective to the beginning of its current fiscal year (January 1, 20X1). [842-10-65-1(b), 250-10-45-14]

The acquiree's transition elections, which we believe the acquiree can make independent of what the acquirer chose for its own adoption (see Question

11.1.40), affect which contracts the acquirer must reassess for lease identification.

- If the transition package of practical expedients is elected (and the land easements practical expedient, if applicable), acquiree contracts entered into or modified (and not meeting the Topic 842 criteria to be accounted for as separate contracts) on or after January 1, 20X1 (acquiree's early adoption effective date) would have been assessed for lease identification using the Topic 842 definition of a lease. Consequently, those contracts are reassessed in accounting for the acquisition because the acquiree had only assessed them under Topic 840. None of the other existing contracts of the acquiree need to be reassessed.
- If neither the transition package of practical expedients nor the land easements practical expedient (if applicable) is elected, *all* of the acquiree's contracts are subject to lease identification reassessment using the Topic 842 definition of a lease. This is because the acquiree would have been required to do so as part of its Topic 842 adoption.

We do not believe this approach is limited only to acquirees that made a formal election to early adopt before the acquisition date. Acquirees may have had no interim financial reporting or other requirement to make such an election in that timeframe. Instead, we believe this approach can be elected after the acquisition date. However, regardless of when it is elected – i.e. before the acquisition date or after the acquisition has closed – the acquirer must follow through on all associated effects of the early adoption. This includes, but is not limited to:

- reflecting such adoption in any stand-alone acquiree financial statements issued on or after the acquisition date; and
- making necessary disclosures about the acquiree's election in the acquirer's post-acquisition financial statements or other SEC filings.



### Example 11.1.10 Reassessing lease identification

#### **Scenario 1: Acquirer and acquiree both adopted Topic 842 before the acquisition date (same adoption date)**

Company AR acquires Lessee LE in a business combination. LE has eight existing contracts (A–H). LE identified Contracts A–F as being leases, and contracts G and H as not containing a lease. The following facts are relevant to AR's evaluation about which contracts should be reassessed as to lease identification.

- The terms and conditions of Contracts A–E are not changed in connection with the acquisition other than to change the named lessee from LE to AR.
- The terms and conditions of Contracts F–H are changed in connection with the acquisition.
- AR determines that LE's lease identification conclusions for contracts A–H are appropriate.

AR's conclusions about which contracts need to be reassessed as to lease identification are as follows.

Contract	Reassessment evaluation
A–E	No reassessment of lease identification occurs. Changing the named lessee from LE to AR is not a change to the terms and conditions of the contract. Additionally, AR has determined that LE's lease identification conclusions for these contracts are appropriate.
F–H	AR reassesses whether these contracts are or contain a lease based on (1) the changed terms and conditions of the contracts, and (2) facts and circumstances as of the acquisition date.

### Scenario 2: Acquirer and acquiree both adopted Topic 842 before the acquisition date (different adoption dates)

The facts are the same as Scenario 1, except that Company AR and Lessee LE adopted Topic 842 on January 1, 20X1 and July 1, 20X1, respectively. Each elected the transition package of practical expedients. The acquisition closes on October 1, 20X1. In addition:

- Contracts A and B were entered into in January 20X0.
- Contracts C and D were entered into in February 20X1.
- Contract E was entered into in May 20X0, and modified in April 20X1. The modification did not add additional goods or services (including any rights to use additional assets) to the contract, and therefore would not have qualified as a separate contract under Topic 842.
- None of contracts A–H are reassessed by LE under Topic 842 between LE's adoption date and the acquisition date.

#### AR elects View 1 to Question 11.1.30

AR's conclusions about which contracts should be reassessed as to lease identification are the same as in Scenario 1.

#### AR elects View 2 to Question 11.1.30

AR's conclusions about which contracts need to be reassessed as to lease identification are as follows.

Contract	Reassessment evaluation
A–B	No reassessment of lease identification occurs. Changing the named lessee from LE to AR is not a change to the terms and conditions of the contract. Additionally, AR has determined that LE's lease identification conclusions for these contracts are appropriate.
C–D	AR reassesses whether these contracts are or contain a lease using the Topic 842 definition of a lease and based on LE's facts and circumstances as of their February 20X1 contract inception dates. AR does not reassess these contracts as of the acquisition date because their terms and conditions are not changed in connection with the acquisition.

Contract	Reassessment evaluation
E	<p>AR reassesses whether this contract is or contains a lease using the Topic 842 definition of a lease and based on LE's facts and circumstances as of the April 20X1 modification date at which AR would have reassessed this contract using the Topic 842 lease definition.</p> <p>AR does not reassess this contract as of the acquisition date because its terms and conditions are not changed in connection with the acquisition.</p>
F–H	AR reassesses whether these contracts are or contain a lease based on (1) the changed terms and conditions of the contracts, and (2) facts and circumstances as of the acquisition date.

### **Scenario 3: Acquirer adopted Topic 842 before the acquisition date, but Acquiree did not**

The facts are the same as Scenario 2, except that LE would have adopted Topic 842 (absent the acquisition) on January 1, 20X3. LE is a calendar year-end reporting company.

#### ***LE does not early adopt Topic 842 before the acquisition occurs***

AR will reassess whether Contracts A–H are or contain leases in accounting for the business combination. Because LE does not early adopt Topic 842, AR accounts for the acquired contracts, including assessing whether those contracts are or contain leases, in the same manner as it would if LE reported its financial statements pre-acquisition under a different basis of accounting (e.g. IFRS Accounting Standards).

#### ***LE early adopts Topic 842 concurrent with the acquisition***

LE early adopts Topic 842 as of the October 1, 20X1 acquisition date, retroactive to the beginning of LE's current fiscal year (January 1, 20X1). LE elects the transition package of practical expedients for its adoption.

Based on this, and the facts and circumstances stipulated in the previous scenarios, AR's conclusions about which contracts need to be reassessed as to lease identification are as follows.

Contract	Reassessment evaluation
A–B	<p>No reassessment of lease identification occurs for these contracts.</p> <ul style="list-style-type: none"> <li>— Changing the named lessee from LE to AR is not a change to the terms and conditions of the contract. Therefore, these contracts' terms and conditions are not changed in connection with the acquisition.</li> <li>— LE elected the transition package of practical expedients, which means it does not need to reassess contracts entered into before, and not modified on or after, January 1, 20X1.</li> <li>— AR has determined that LE's lease conclusions for these contracts are appropriate.</li> </ul>
C–D	These contracts are reassessed as to whether they are or contain a lease using the Topic 842 definition of a lease and based on LE's facts and circumstances as of their February 20X1 contract inception dates.

Contract	Reassessment evaluation
	These contracts are not reassessed as of the acquisition date because their terms and conditions are not changed in connection with the acquisition.
E	<p>This contract is reassessed as to whether it is or contains a lease using the Topic 842 definition of a lease and based on LE's facts and circumstances as of the April 20X1 modification date. This is because LE's early adoption, retroactive to January 1, 20X1, means LE should have assessed this contract on that date using the Topic 842 lease definition.</p> <p>This contract is not reassessed as of the acquisition date because its terms and conditions are not changed in connection with the acquisition.</p>
F–H	AR reassesses whether these contracts are or contain a lease based on (1) the changed terms and conditions of the contracts, and (2) facts and circumstances as of the acquisition date.

## 11.1.2 Lease classification



Question 11.1.60

### Reassessment of lease classification – lease is modified in a business combination

**Is the acquiree's lease classification reassessed when there is a lease modification in connection with a business combination?**

**Background:** A lease modification is a change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease. [842 Glossary]

**Interpretive response:** Yes. The classification of an acquired lease is reassessed if there is a lease modification enacted as part of the business combination (or acquisition of a not-for-profit entity) and that modification is not accounted for as a separate contract. [842-10-55-11]

#### Changes to a lease agreement that are not lease modifications

A lease agreement may be modified to reflect a change in the identity of one of the parties to the agreement (novation) as a result of the business combination. Such amendments are not 'lease modifications' (as defined in Topic 842) because they do not change the scope of, or consideration for, the lease. Therefore, lease classification is not reassessed.

#### Anticipated lease modifications

An acquirer also does not reassess the classification of an acquired lease in contemplation of a lease modification – i.e. even if the acquirer has a clear

intent to modify the acquired lease, this does not alter its acquisition-date classification. The acquirer will reassess the lease's classification on the effective date of the modification. [842-10-55-11]



### Question 11.1.70 Acquiree's lease classification retained from Topic 840

**Does the acquirer retain the acquiree's lease classification if it was determined by the lessee under Topic 840 and retained via the transition package of practical expedients in adopting Topic 842?**

**Background:** If an acquiree (lessee or lessor) elected the package of transition practical expedients in adopting Topic 842 (see sections 13A.2.3 and 13B.2.3), its classification for leases that commenced before the effective date of Topic 842 will be based on the classification guidance in Topic 840 (unless the classification has been reassessed in accordance with Topic 842 after the effective date).

If a business combination, acquisition of a not-for-profit entity or an asset acquisition occurs on or after the effective date, a question arises about whether lease classification should be reassessed under Topic 842.

Question 11.1.75 addresses reassessing lease classification if the acquiree has not yet adopted Topic 842.

**Interpretive response:** Yes, the acquiree's lease classification should be retained, unless the following applies.

- It is a business combination or acquisition of a not-for-profit entity and the lease is modified as part of the acquisition (and that modification is not accounted for as a separate contract); see Question 11.1.60. [842-10-55-11]
- It is an asset acquisition and one of the specific reassessment circumstances outlined in Question 11.1.90 occurs in connection with the asset acquisition.



### Question 11.1.75 Reassessment of lease classification – only the acquirer has adopted Topic 842

**Does the acquirer need to reassess the acquiree's lease classification if the acquirer has adopted Topic 842 before the acquisition date, but the acquiree has not?**

**Background:** Assume an acquirer adopted Topic 842 on January 1, 20X1, while the acquiree had not yet adopted Topic 842 on the October 1, 20X1 business combination date – e.g. because it was a private company. Therefore, all of the

acquiree's pre-acquisition lease classification conclusions were reached under Topic 840, which may differ from those that would have been reached under Topic 842.

The question arises about whether the acquirer must reassess the acquiree's lease classification conclusions using the Topic 842 classification criteria.

**Interpretive response:**

**Acquiree does not early adopt Topic 842**

If the acquiree does not early adopt Topic 842 before the acquisition occurs, we believe the acquiree's accounting under Topic 840 is like a situation in which the acquiree's accounting is under IFRS Accounting Standards or other GAAP that is not US GAAP (see Question 11.1.95).

We do not believe the business combination classification reassessment exemption in paragraph 842-10-55-11 applies when the acquiree's lease classification was determined under Topic 840 (other than as described in Question 11.1.70). This is because that paragraph expressly refers to retaining the previous lease classification 'in accordance with this Subtopic'; lease classification determined under Topic 840 is not in accordance with Subtopic 842-10.

Under this view, which treats Topic 840 like IFRS Accounting Standards or other local GAAP, the acquirer reassesses all of the acquiree's lease classification conclusions using the Topic 842 classification criteria as of the date that the acquiree would have undertaken that assessment had it adopted Topic 842 at the same date as the acquirer.

**Acquiree early adopts Topic 842**

Topic 842 permits early adoption (see sections 13A.1 and 13B.1). Therefore, the acquiree could have early adopted Topic 842 immediately before the acquisition closes, *with retrospective effect to the beginning of its current fiscal year*.

Using the acquiree in the background example, and assuming the acquiree has a calendar fiscal year, it could have early adopted Topic 842 immediately before the acquisition closes on October 1, 20X1, effective from the beginning of its current fiscal year (January 1, 20X1). [842-10-65-1(b), 250-10-45-14]

The acquiree's transition elections, which we believe the acquiree can make independent of what the acquirer chose for its own adoption (see Question 11.1.40), affect whether the acquirer must reassess the acquiree's lease classification conclusions.

- If the transition package of practical expedients is elected by the acquiree, it would have conducted a lease classification assessment of its leases entered into or modified (and not meeting the Topic 842 criteria to be accounted for as separate contracts) on or after January 1, 20X1 (acquiree's early adoption effective date) using the Topic 842 classification criteria. Consequently, those contracts are reassessed in accounting for the acquisition because the acquiree had assessed them only under Topic 840. The acquirer does not need to reassess lease classification for leases that commenced before January 1, 20X1.
- If the transition package of practical expedients is not elected, all of the acquiree's leases are subject to classification reassessment using the Topic

842 classification criteria. This is because the acquiree would have been required to do so as part of its Topic 842 adoption.

We do not believe this approach is limited only to acquirees that made a formal election to early adopt before the acquisition date. Acquirees may have had no interim financial reporting or other requirement to make such an election in that timeframe. Instead, we believe this approach can be elected after the acquisition date. However, regardless of when it is elected – i.e. before or after the acquisition date – the acquirer must follow through on all associated effects of the early adoption. This includes, but is not limited to:

- reflecting such adoption in any stand-alone acquiree financial statements issued on or after the acquisition date; and
- making necessary disclosures about the acquiree's election in the acquirer's post-acquisition financial statements or other SEC filings.



#### Question 11.1.80

##### **Reassessment of lease classification – acquirer's assessment of lease term or purchase option is different from acquiree's in a business combination**

**Is the acquiree's lease classification reassessed when the acquirer's assessment of the lease term or a lessee purchase option is different from the acquiree's pre-acquisition assessment in a business combination?**

**Interpretive response:** No. The fact that the acquirer's assessment of the lease term or the likelihood of purchase option exercise by the lessee is different from the acquiree's is not in itself a lease classification reassessment event in a business combination. [842-10-25-1, 55-11]

In contrast, in an asset acquisition, this *would* require reassessment of the lease classification if the acquiree was the lessee in the lease (see Question 11.1.90).



#### Question 11.1.90

##### **Reassessment of lease classification – lease is acquired in an asset acquisition**

**Is the classification of an existing lease reassessed when the lease is acquired in an asset acquisition?**

**Interpretive response:** It depends. This is because under Topic 842 the classification of a lease is reassessed only in specific circumstances. These are when there is a: [842-10-25-1]

- lease modification not accounted for as a separate contract (*all entities*);
- change in the lease term (*lessees only*); or

- change in the assessment of whether a lessee is reasonably certain to exercise a purchase option (*lessees only*).

Absent one of these, lease classification is not reassessed. Therefore, acquisition of the lease alone would not result in reassessing lease classification. One of the above would have to occur in connection with the asset acquisition for lease classification to be reassessed, such as if:

- the lease were modified in connection with the acquisition; or
- the acquiree was the lessee in the acquired lease, and the acquirer, in measuring the lease liability and ROU asset in accordance with paragraph 805-20-30-24, reaches a different assessment of the lease term than that of the acquiree immediately before the acquisition date.

The definition of 'lease modification' should be considered when deciding whether a lease is modified in connection with an acquisition. Topic 842 defines a lease modification as "a change in the terms and conditions that results in a change in the scope of or the consideration for a lease." Therefore, if the only change to the lease agreement involves replacing the name of one of the parties to the lease with the name of the acquirer, no lease modification has occurred. [\[842 Glossary\]](#)

Question 11.1.20 addresses situations where the acquiree's lease classification is not known.



### Question 11.1.95

**Reassessment of lease classification – acquiree's assessment not made under US GAAP**

#### Should the acquirer reassess the acquiree's lease classification conclusions if they were not reached under US GAAP?

**Background:** Paragraph 11.1.10 (Note 1) and Question 11.1.90 address when an acquirer should reassess the classification of an acquired lease in a business combination and asset acquisition, respectively.

This question addresses whether those same conclusions apply if the acquiree classified the lease on the basis of other GAAP (e.g. IFRS Accounting Standards or GASB standards).

**Interpretive response:** Yes. When an acquiree's accounting pre-acquisition is not under US GAAP, the acquirer must convert it to US GAAP. Regardless of whether the transaction is a business combination or an asset acquisition, this includes reassessing, using the Topic 842 classification criteria, lease classification conclusions reached by the acquiree under other GAAP.

We do not believe paragraph 842-10-55-11 applies when the acquiree's lease classification was determined under other GAAP. This is because that paragraph expressly refers to retaining the previous lease classification 'in accordance with this Subtopic'; lease classification determined under other GAAP is not in accordance with Subtopic 842-10. In addition, retaining previous lease classification would be meaningless if the other GAAP did not include a

requirement to classify leases (e.g. IFRS 16 does not permit or require classification of leases by lessees).

When this occurs, the acquirer will need to determine what the acquiree's pre-acquisition lease classification would have been under Topic 842 based on the acquiree's business and the facts and circumstances as of the date the acquiree would have undertaken that assessment

### 11.1.3 Acquisition date recognition and measurement



#### Observation

##### **Measurement of lease assets and lease liabilities is not at fair value**

11.1.30 The business combinations guidance generally requires all assets acquired and liabilities assumed to be measured at fair value as of the acquisition date. However, the Board concluded that requiring acquirers to measure lease assets and lease liabilities at fair value was not justifiable from a cost-benefit perspective. This is because of the likely difficulties and cost of obtaining reliable fair value measurements for those items, particularly ROU assets. [\[IASU 2016-02.BC416–BC417\]](#)

11.1.40 However, the Board believed that the measurement requirements for acquired lease assets and lease liabilities will, at least in many cases, reasonably approximate fair value. For example, the Board observed that, for lessors, the acquisition-date net investment in the lease measured under Topic 805 (as amended) will generally equal the acquisition-date fair value of the underlying asset; for lessees, the net carrying amount of the ROU asset and the lease liability recognized by the acquirer will generally approximate the fair value of the lease. [\[IASU 2016-02.BC416–BC417\]](#)

#### **Prepaid or accrued rent**

11.1.50 Prepaid or accrued rent (of lessees or lessors) is not recognized in the acquisition accounting because those amounts do not meet the definition of an asset or a liability. Instead, the remaining lease payments affect whether the lease, as of the acquisition date, is at market terms. This means that if the lease payments are significantly front- or back-loaded, at the acquisition date this may result in a conclusion that the terms and conditions of the lease are off-market – e.g. because the remaining lease payments may be significantly less than or greater than the lease payments would be for a new lease with a term equal to the remaining lease term at the acquisition date. [\[IASU 2016-02.BC415\]](#)

#### **Variable lease payments**

11.1.60 Variable lease payments that do not depend on an index or rate (e.g. based on a percentage of estimated future sales) are not recognized outside of a business combination until the obligation for those payments is incurred (lessees, see paragraph 6.4.200) or the payments are earned (lessors).

However, the existence of variable lease payments for a lease may affect the determination of whether the terms of the lease are favorable or unfavorable.

- For the lessee, the favorability or unfavorability arising from the variable lease payments will affect the measurement of the acquired ROU asset.
- For the lessor, the favorability or unfavorability arising from the variable lease payments will affect the (1) measurement of the intangible favorable lease asset or unfavorable lease liability in an operating lease, or (2) fair value of the underlying asset in a sales-type or direct financing lease.

### **Short-term leases – practical expedient for lessees only**

11.1.70 An acquirer may elect, as an accounting policy (by class of underlying asset), not to recognize ROU assets or lease liabilities for leases that, at the acquisition date, have a remaining lease term of 12 months or less. In that case, the acquirer does not recognize any asset or liability for favorable or unfavorable terms relative to market. [805-20-25-28B]

11.1.80 This election applies to all of an acquirer's acquisitions – i.e. it cannot be applied to select leases that meet the criterion, or to select acquisitions. This policy election is independent of the lessee's election of the short-term lease recognition and measurement exemption (see section 6.3.1). In other words, an entity can elect this practical expedient for all short-term leases acquired in acquisitions while not electing the lessee short-term lease exemption for its own leases, or vice versa. [805-20-25-28B]



#### Question 11.1.100

#### **Incremental borrowing rate to use when measuring an acquired lease – implicit rate not readily determinable**

**Is the discount rate for an acquired lease the incremental borrowing rate of the acquirer or of the acquiree when the implicit rate is not readily determinable?**

**Background:** For leases in which the acquiree is a lessee, the acquirer measures the lease liability at the present value of the remaining lease payments, as if the acquired lease were a new lease *of the acquirer* at the acquisition date. [805-20-30-24]

Because of the italicized language, the question has arisen about whether this means the acquirer should, when the rate implicit in the lease is not readily determinable, always use *its* incremental borrowing rate when measuring the acquired lease liability; or whether, in some cases, the incremental borrowing rate should continue to be that of the *acquiree* – e.g. when the acquiree remains the legal counterparty to the lease.

**Interpretive response:** We believe the key language in the measurement guidance outlined in the background is 'as if the acquired lease were a new lease'. We believe this language makes it clear that the acquirer does *not* retain

the acquiree's pre-acquisition discount rate for the lease because a new lease is measured using an updated discount rate (i.e. as of the commencement date).

However, we also do not believe this language, or the italicized language in the background, automatically means the acquirer will use its own, parent/group incremental borrowing rate as the discount rate for the acquired lease.

Instead, we believe the facts and circumstances will determine whether the discount rate for the acquired lease should be either:

- the acquirer's incremental borrowing rate; or
- the acquiree's incremental borrowing rate, reassessed as of the acquisition date and taking into account the acquiree's current credit characteristics and credit standing as part of the acquirer's consolidated group.

If the acquirer becomes the legal counterparty to the lease (e.g. through a contract modification or a permitted/required assignment of the lease to the acquirer), we believe it should use its own incremental borrowing rate, just as it would for a new lease to which it is the legal counterparty.

In contrast, if the acquiree remains the legal counterparty to the lease (e.g. as a subsidiary of the acquirer), we believe the question about which of the above borrowing rates to use is fundamentally no different from the question about whether to use the parent or the subsidiary's incremental borrowing rate to measure a new lease entered into by a subsidiary. Consequently, we believe the same considerations outlined in Question 5.6.50 generally apply.



### Question 11.1.110 In-place leases

#### Does an in-place lease at the acquisition date create an intangible asset for the acquirer?

**Background:** An acquirer may identify value associated with leases in place at the acquisition date. Value related to in-place leases may reflect, for example, the value associated with avoiding the costs of originating the acquired in-place leases, as well as the value associated with the avoidance of holding costs that would be incurred if an asset intended to be leased was acquired without a lessee. Origination costs comprise the costs to execute similar leases, including marketing costs, leasing commissions, legal and other related costs.

**Interpretive response:** Neither Topic 842 nor Topic 805 (either before or as amended by ASU 2016-02) explicitly address the recognition of in-place lease intangible assets. And while we acknowledge that there is an alternative view that a separate intangible asset for in-place leases should not be recognized by an acquirer in a business combination, consistent with our view under Topic 840 and Topic 805 before ASU 2016-02, we believe an acquirer should separately measure an intangible asset for in-place leases on a lease-by-lease basis; see chapter 7 of KPMG Handbook, [Business combinations](#).

The intangible asset recognized in accordance with Topic 805 (as amended) for an in-place lease should be recognized and reported separately in the financial

statements. We do not believe that it should be combined with the acquired lease assets (i.e. lessee ROU assets, or lessor lease receivables and unguaranteed residual assets), or with other lease-related intangibles (e.g. favorable lease assets or unfavorable lease liabilities of operating lessors).



### Question 11.1.120

#### **Subleases of an acquiree**

### **How should an acquirer consider favorable or unfavorable sublease terms of an acquired lease?**

**Interpretive response:** An acquiree may be party to a sublease agreement. For example, a sublease exists when the acquiree, as the original lessee under a lease, subleases some or all of its right to use the underlying asset to a third party.

Favorable or unfavorable terms of the head lease will affect the measurement of the head lease ROU asset just as they would if there were no sublease. Meanwhile, favorable or unfavorable terms of the sublease result in the acquirer separately recognizing an intangible favorable sublease asset or unfavorable sublease liability. The acquirer does not net any off-market terms in the head lease against any off-market terms in the sublease.



### Question 11.1.130

#### **Preexisting lease relationship**

### **How should the acquirer account for a preexisting lease between the acquirer and the acquiree at the acquisition date?**

**Interpretive response:** An acquirer may have a preexisting lease with the acquiree, either as the lessee in that arrangement or as the lessor.

Regardless of whether there are noncontrolling interests after the acquisition, at the acquisition date, the lease becomes an intercompany lease and is effectively settled. This means the acquirer will not recognize any lease assets or lease liabilities related to the preexisting lease. Instead, the acquirer accounts for the settlement separately from the business combination, recognizing a gain or loss on the settlement of the lease in an amount equal to the lesser of:

[805-10-55-21(b)]

- the amount by which the lease is favorable or unfavorable from the perspective of the acquirer relative to market terms; and
- the amount of any stated settlement provisions in the lease available to the counterparty for whom the contract is unfavorable.

In addition, the acquirer derecognizes any previously recognized assets or liabilities related to the lease as part of the effective settlement of the arrangement. The carrying amounts of any recognized assets or liabilities adjust the amount of the gain or loss recognized for the settlement of the preexisting relationship, as illustrated in Example 3 in Section 805-10-55. See also paragraph 11.011 and Example 11.3 in KPMG Handbook, **Business combinations.** [805-10-55-33]



### Question 11.1.140

#### **Favorability or unfavorability associated with a renewal option**

### **How should an acquirer account for favorability or unfavorability associated with a renewal option in an acquired lease?**

#### **Interpretive response:**

##### **Acquiree is the lessee**

A renewal period that is part of the lease term factors into the assessment of whether the acquired lease is at favorable or unfavorable terms. Therefore, the favorability or unfavorability of a renewal option (including an option not to terminate the lease) that is reasonably certain to be exercised by the lessee, or that the lessor can require the lessee to exercise, is considered in measuring the acquired ROU asset.

When a renewal period is *not* part of the lease term, we believe the treatment of the renewal option generally depends on whether it is favorable or unfavorable to the lessee.

- A *favorable* renewal option factors into the measurement of the acquired ROU asset.
- An *unfavorable* renewal option does not affect the measurement of the ROU asset unless an unrelated third party can force its exercise because a lessee would not be expected to exercise an unfavorable option.

##### **Acquiree is the lessor**

The favorability or unfavorability of an option for a renewal period that is part of the lease term affects either:

- the measurement of any favorable lease asset or unfavorable lease liability recognized by the acquirer if the acquired lease is an operating lease; or
- the measurement of the lease receivable and the unguaranteed residual asset (see Question 11.1.80).

When a renewal period is *not* part of the lease term, we believe the treatment of the renewal option depends on whether it is favorable or unfavorable to the lessor.

- A *favorable* renewal option (i.e. unfavorable to the lessee) is generally ascribed no value in acquisition accounting, unless there are unusual

circumstances that indicate the lessee is likely to exercise the option anyway, in which case the option would create an asset for the acquirer.

- An *unfavorable* renewal option (i.e. favorable to the lessee) generally creates a liability for the acquirer.

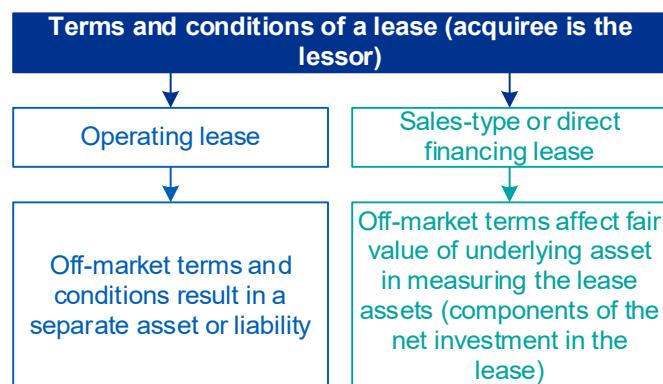


### Question 11.1.150

#### **Lease classification impact on the measurement of underlying assets**

#### **When the acquiree is the lessor, does the lease classification affect the measurement of the underlying asset's fair value in acquisition accounting?**

**Interpretive response:** Yes. When the acquiree is the lessor, the terms and conditions of the lease affect the acquisition accounting differently depending on the lease classification. [805-20-30-25]



This difference means that acquirers of lessors will measure the fair value of the underlying asset differently depending on the classification of the lease to which the underlying asset relates. Question 11.1.160 discusses how off-market terms affect lessors' accounting for acquired sales-type and direct financing leases.

We believe the Board's decisions in this regard principally stem from its desire to retain Topic 840 lessor accounting in most respects. Under Topic 840, acquirers generally already consider lease terms and conditions in valuing lessor lease assets for acquired sales-type or direct financing leases and recognize favorable (unfavorable) assets (liabilities) for acquired operating leases.



### Question 11.1.160

#### **How off-market lease terms affect the fair value of the underlying asset in sales-type and direct financing leases – lessors**

#### **How do off-market terms affect the fair value of the underlying asset in lessors' accounting for acquired sales-type and direct financing leases?**

**Background:** At the acquisition date, an acquirer lessor recognizes a lease receivable and an unguaranteed residual asset. Paragraph 11.1.10 outlines how those amounts, totaling to the net investment in the acquired lease, are calculated, noting that: [805-20-30-25]

- the fair value of the underlying asset as of the acquisition date is a key input to the measurement of the newly acquired net investment in the lease and its components, the lease receivable and the unguaranteed residual asset; and
- the fair value of the underlying asset is affected by the terms and conditions of the acquired lease.

Neither Topic 805 nor Topic 842 explain or illustrate how to factor the terms and conditions of the acquired lease into the fair value of the underlying asset.

For context, consider a scenario in which Company AR acquires Lessor LR. LR has an existing lease with a customer for a long-lived equipment asset. The lease is classified as a sales-type lease by LR and lease classification is not reassessed by AR; see Note 1 to the table in paragraph 11.1.10 and Question 11.1.90. At the acquisition date, the lease pricing is above market (i.e. favorable) or below market (i.e. unfavorable) to AR compared to market terms.

**Interpretive response:** The favorability or unfavorability of an acquired sales-type or direct financing lease results in an adjustment to the estimated fair value of the underlying asset, and consequently affects the measurement of the net investment in the lease (and its components, the lease receivable and the unguaranteed residual asset). This is in contrast to an operating lease, where off-market terms result in separate recognition of a favorable lease asset or unfavorable lease liability.

This approach for acquired sales-type or direct financing leases means that the acquisition-date fair value of the acquired underlying asset will be higher or lower than the fair value of an equivalent asset sold in an orderly transaction between market participants; the difference is the amount by which the lease is off-market. The amount of that adjustment is calculated in the same manner as favorability/unfavorability is calculated for an operating lease.

Adjusting the fair value of the underlying asset affects the acquisition date measurement of the acquired lease receivable and acquired unguaranteed residual asset.

## Measuring the net investment in the lease and its components

### ***Lease receivable***

The *undiscounted* lease payments and guaranteed residual value are measured at the acquisition date in the same manner as if the acquired lease were a new lease. However, the adjustment to the fair value of the underlying asset (for the off-market terms) results in a rate implicit in the lease that differs from what it would be if the lease were priced at market. This is because the implicit rate depends on the fair value of the underlying asset (see section 5.6.1).

Consequently, the measurement of the lease receivable, which is discounted at the rate implicit in the lease, differs from what it would be if the lease were priced at market.

### ***Unguaranteed residual asset***

The acquisition-date unguaranteed residual asset is affected by the fair value of the underlying asset because, as outlined in the table in paragraph 11.1.10, it is measured as the difference between the fair value of the underlying asset and the lease receivable.

### ***Net investment in the lease***

The acquisition date net investment in the lease equals the sum of the acquisition date:

- lease receivable; and
- unguaranteed residual asset.

Therefore, because the measurement of those items is affected by the off-market adjustment to the fair value of the underlying asset, so is the measurement of the net investment in the lease.

### ***Putting it all together***

Off-market terms of an acquired sales-type or direct financing lease will result in the following acquisition-date accounting process for the acquirer related to that lease.

- **Step 1:** Determine the fair value of the underlying asset without consideration of the off-market terms of the acquired lease.
- **Step 2:** Calculate the off-market adjustment.
- **Step 3:** Adjust the fair value determined in Step 1 by the off-market adjustment calculated in Step 2.
- **Step 4:** Measure the lease receivable, unguaranteed residual asset and net investment in the lease as outlined above.

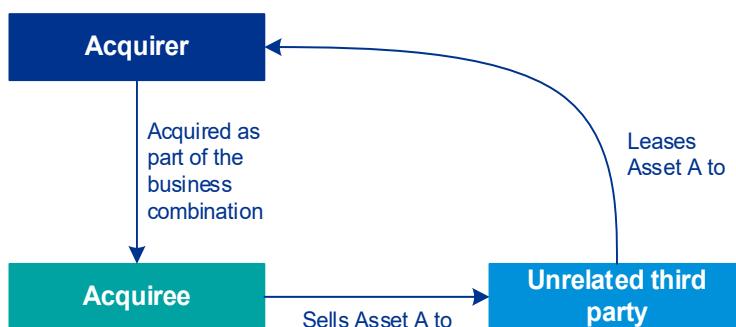


### Question 11.1.170

#### Involvement of a third-party lessor in a business combination

##### How should an acquirer account for a lease when a third party becomes a lessor as part of the acquisition?

**Interpretive response:** In certain business combinations, an unrelated third party may acquire an asset directly from the acquiree, and in turn lease that asset to the acquirer.



If the transaction between the acquiree and the unrelated third party is contingent on the business combination between the acquirer and the acquiree, the acquirer should account for the sale of the asset by the acquiree and the lease from the unrelated third party as a sale-leaseback transaction (see chapter 9).

The acquirer should also account for the sale of the asset by the acquiree and the lease from the unrelated third party as a post-acquisition sale-leaseback transaction if the transaction between the acquiree and the unrelated third party is entered into either (1) after or (2) at or near the same time as the business combination is agreed to by the acquiree and the acquirer. In such cases, it should be presumed that the sale of the asset by the acquiree to the unrelated third party contemplated the subsequent lease of that asset to the acquirer.



### Question 11.1.180

#### Acquisition accounting for an acquiree failed sale/purchase

##### How should an acquirer account for the failed sale or failed purchase of an acquiree in a sale-leaseback transaction?

**Interpretive response:** We believe the business combination does not eliminate the failed sale (if the acquiree is the seller-lessee) or the failed purchase (if the acquiree is the buyer-lessor).

The acquirer should continue with the failed sale/purchase accounting until the transaction meets the requirements in Subtopic 842-40 for a sale/purchase. The

assets and liabilities of the acquiree related to the failed sale-leaseback transaction (e.g. the underlying asset and financial liability if the seller-lessee or the financial receivable if the buyer-lessor) are still subject to any appropriate adjustments to those assets and liabilities as required by Topic 805.



### Question 11.1.190

#### **Accounting for leases acquired in an asset acquisition**

#### **How should lease assets and lease liabilities in an asset acquisition be accounted for?**

**Background:** Topic 805 (pre- and post-ASU 2016-02) does not contain guidance on the accounting for leases acquired in an asset acquisition – i.e. from the acquisition of assets that have a lease (or leases) attached that do not constitute a business.

**Interpretive response:** In an asset acquisition, in general, we believe the acquired leases should be accounted for in the same manner as they would be if they were acquired in a business combination – i.e. measured as if the lease were a new lease of the acquirer at the acquisition date.

However, because an entity does not recognize goodwill or a bargain purchase gain in an asset acquisition, the amounts recognized for the lease may be adjusted to relative fair value from what would have been recognized in accordance with Topic 805. For example, an acquired ROU asset (lessee) measured in accordance with paragraph 805-20-30-24, or a favorable operating lease asset (lessor) recognized in accordance with paragraph 805-20-25-12, may be further adjusted to relative fair value if the purchase price of the acquired assets (including transaction costs) is different from their aggregate fair value.



### Question 11.1.200

#### **Different acquirer/acquiree separation of lease and non-lease component policy elections**

#### **Does an acquirer measure an acquired lease based on its accounting policy to separate or not separate lease and non-lease components if it differs from that of the acquiree?**

**Background:** An acquirer's accounting policy to separate lease from non-lease components, or vice versa, may differ from the acquiree's (see section 4.4.1).

In addition to the measurement difference that would result from the acquirer remeasuring the lease at the acquisition date based on its own accounting policy, the acquiree's election, if a lessee, might have resulted in a different lease classification from what would have resulted from applying the acquirer's accounting policy. For example, the acquiree's election as a lessee to separate lease and non-lease components might have resulted in operating lease

classification for an acquired lease, while a non-separation accounting policy election would have resulted in finance lease classification for the same lease.

Questions arising when this accounting policy difference exists include the following.

- Does the acquirer *measure* the acquired leases based on its separation or non-separation accounting policy?
- Should the acquirer *reassess* the *classification* of the acquired lease, because of the effect the different accounting policy might have had on the acquiree's lease classification (if a lessee)?

**Interpretive response:** As outlined in chapter 7 of KPMG Handbook, [Business combinations](#), accounting policies that apply to assets acquired and liabilities assumed from an acquiree generally should be conformed to those of the acquirer after a business combination. Therefore, we believe the acquirer should follow its own separation or non-separation accounting policy when *measuring* the acquired lease asset and/or liability, regardless of whether the acquiree was the lessee or the lessor in the lease.

However, an acquirer should *not* reassess the classification of the acquired lease in these circumstances, even though it might have differed had the acquiree been following the same separation or non-separation accounting policy as the acquirer. This is because, as outlined in paragraph 11.1.10 (Note 1) and Question 11.1.60, Topic 842 does not permit an acquiree to reassess the classification of an acquired lease unless the lease is modified in connection with the business combination (and that modification is not accounted for as a separate contract). [842-10-55-11]



### Question 11.1.210

#### Measurement of acquired related party leases with off-market terms

#### Are off-market terms of an acquired related party lease reflected in the measurement of the post-acquisition ROU asset?

**Background:** An acquirer may acquire a lease in a business combination (or an asset acquisition) that either was pre-acquisition and remains, or becomes as a consequence of the acquisition, a related party lease.

Under Topic 842, entities account for related party leases based on their enforceable (or written – see section 3.1.2) terms and conditions. That is, entities do *not* make adjustments to their related party lease accounting for off-market terms or conditions. [842-10-55-12, ASU 2016-02.BC374]

However, as shown in paragraph 11.1.10 (table), the carrying amount of an ROU asset acquired in a business combination (or asset acquisition – see Question 11.1.190) is adjusted from the carrying amount of the lease liability for any above- or below-market terms. [805-20-30-24]

The related party lease discussion does not explicitly reference such leases acquired in a business combination (or asset acquisition), while the acquired

lease measurement guidance in Topic 805 does not refer to related party leases. Therefore, the question arises about whether the Topic 805 requirement to adjust the measurement of an acquired ROU asset for off-market lease terms applies to an acquired related party lease.

**Interpretive response:** Yes. Despite the related party lease guidance, we believe the acquirer adjusts the carrying amount of the ROU asset for any above- or below-market terms of the related party lease. This is because of the particular wording in paragraph 805-20-30-24.

We believe that wording requires:

- the lease liability to be measured first on the same basis as any new lease, which for a related party lease means based on the legally enforceable terms and conditions of the lease; and
- the ROU asset to be measured second, without any reference to measuring as if a new lease, based on the measurement of the lease liability as adjusted for any off-market terms.

In addition to the wording in Topic 805, we believe that to not adjust the acquired ROU asset for off-market terms would inappropriately record the off-market effects of the lease through goodwill; more commonly, inflating it because of below-market terms.

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## Acquisition date recognition and measurement examples



### Example 11.1.20

#### Accounting for an acquired lease (operating lease)

##### Scenario 1: Lease is at market terms at the acquisition date (acquiree is the lessee)

Company AR acquires Lessee LE, which leases its main transportation hub from Lessor LR. The hub comprises a large building and surrounding land near a major airport that serves as a storage and processing facility.

The following facts about the underlying lease (an operating lease) are relevant.

Lease term:	25 years
Lease payments:	Fixed payments of \$1 million per year in arrears, with a 3% increase each year after Year 1
RVG:	None
Options:	None
At lease commencement:	
— Fair value of building and surrounding land:	\$30 million
— Remaining economic life of building:	45 years
— LE's incremental borrowing rate:	7%

The lease is not modified in connection with the business combination. The following facts at the acquisition date are relevant.

Lease term remaining:	19 years
Lease terms:	At market
Accrued rent liability:	\$2,281,810 <sup>1</sup>
AR's incremental borrowing rate:	8% <sup>2</sup>

AR recognizes a lease liability and an ROU asset. There are no other identifiable intangible assets associated with the lease (see paragraph 11.1.10).

Lease liability:	\$14,177,968 <sup>3</sup>
ROU asset:	\$14,177,968 <sup>4</sup>
Intangible assets (associated with the lease):	None

AR does not reassess LE's conclusion that the arrangement is a lease, and AR retains LE's classification of the lease. AR accounts for the remainder of the lease as if it is a new operating lease for the same facility commencing on the acquisition date.

Notes:

1. The difference between the lease payments made through the end of Year 6 of \$6,468,410 and the straight-line lease cost recognized of \$8,750,220 (((\$36,459,250 total lease payments / 25) × 6).
2. AR cannot readily determine LR's implicit rate for the lease. AR legally assumes the lease from LE in connection with the acquisition.
3. The present value of the remaining lease payments due under the lease.
4. Equal to the lease liability. No adjustment is required to the ROU asset because the terms of the lease are at market at the acquisition date. The ROU asset is also not adjusted for LE's pre-acquisition accrued rent liability, which is not carried forward in the acquisition accounting.

### Scenario 2: Lease is at market terms at the acquisition date (acquiree is the lessor)

Assume the same facts as in Scenario 1 except for the following.

- Company AR is acquiring Lessor LR, rather than Lessee LE.
- The building and the land (i.e. the assets subject to the lease with LE) have fair values of \$16 million and \$12 million, respectively.

Because the acquiree is the lessor in the operating lease and the lease is at market terms at the acquisition date, AR recognizes the land and building, but no other assets or liabilities.

Land:	\$12 million <sup>1</sup>
Building:	\$16 million <sup>2</sup>
Asset or liability (off-market lease terms):	N/A
Intangible assets (associated with the lease):	None

**Notes:**

1. AR recognizes the land at its fair value. AR will not depreciate the land subsequently.
2. AR recognizes the building at its fair value. AR will depreciate the building over its remaining useful life, which is not necessarily the same as its remaining economic life (see section 5.7).

AR does not recognize an accrued rent asset for the difference between the income recognized by LR on a straight-line basis before the acquisition date and the lease payments made through the acquisition date by LE – i.e. the \$2,281,810 calculated in Scenario 1.

**Scenario 3: Lease is at below-market rates at the acquisition date (acquiree is the lessee)**

Assume the same facts as in Scenario 1 except that, at the acquisition date, the terms of the lease to Lessee LE are considered favorable compared to market terms. Although the Year 7 lease payment is reasonable compared to market rental terms, lease payments in this market should be increasing by 4% per year thereafter.

Contractual payments in Years 7 – 25 (undiscounted):	\$29,990,840	\$1,194,052 in Year 7, increasing by 3% each of the 18 years thereafter
Market-based payments in Years 7 – 25 (undiscounted):	\$33,040,903	\$1,194,052 in Year 7, increasing by 4% each of the 18 years thereafter

Company AR recognizes a lease liability and an ROU asset. Consistent with Scenario 1, there are no other identifiable intangible assets associated with the lease (see paragraph 11.1.10).

Lease liability:	\$14,177,968
ROU asset:	\$15,278,427 <sup>1</sup>
Intangible assets (associated with the lease):	None

**Note:**

1. While the lease liability at the acquisition date is the same as in Scenario 1 (based on contractual lease payments), the ROU asset is \$15,278,427. This is because the asset is based on the present value of the market-based rental payments. The difference between the ROU asset and the lease liability of \$1,100,459 reduces the goodwill recognized in AR's acquisition accounting, and will be recognized as additional operating lease cost over the 19-year remaining lease term.

**Scenario 4: Lease is at below-market rates at the acquisition date (acquiree is the lessor)**

Assume the same facts as in Scenario 3 except that Company AR is acquiring Lessor LR, rather than Lessee LE. In addition, assume AR's rate implicit in the lease at the acquisition date is 7.85%.

Because the acquiree is the lessor in the operating lease, AR recognizes the following.

Land:	\$12 million
Building:	\$16 million
Liability (off-market lease terms):	\$1,119,754 <sup>1</sup>
Intangible assets (associated with the lease):	None
Note:	
1. The difference between the present value (using the implicit rate of 7.85%) of the remaining lease payments (\$14,348,787) and the present value (using the implicit rate of 7.85%) of the remaining market-based rental payments (\$15,468,541) is recognized as an unfavorable lease liability in AR's acquisition accounting. This liability increases the goodwill recognized by AR in the acquisition accounting, and will be recognized as additional lease income over the 19-year remaining lease term (dr. unfavorable lease liability, cr. lease income).	



### Example 11.1.30

#### Accounting for an acquired lease (finance/sales-type lease)

##### Scenario 1: Acquiree is the lessor

Company AR acquires Lessor LR, which leases manufacturing equipment to its customers. The following facts about one of those leases (a sales-type lease, properly classified) to Lessee LE are relevant.

Lease term:	5 years
Lease payments:	Fixed payments of \$165,000 per year in arrears, with a 4% increase each year after Year 1
End of lease:	Ownership transfers to LE for no additional consideration
At lease commencement:	
— Fair value of the equipment:	\$700,000
— Rate implicit in the lease:	8.49%

The following facts at the acquisition date are relevant.

Lease term remaining:	4 years
Lease terms:	At market
Fair value of the equipment:	\$600,000
Rate implicit in the lease:	8.08%

The underlying asset is not recognized in AR's acquisition accounting. Instead, AR recognizes a lease receivable of \$600,000, which equals the remaining lease payments of \$728,694 discounted at the acquisition date implicit rate of 8.08%. There is no unguaranteed residual asset to recognize because LE obtains ownership of the equipment at the end of the lease term; therefore, the net

investment in the lease is also \$600,000, equal to the lease receivable. Subsequent to the acquisition date until the end of the lease term, AR accounts for the acquired lease in the same manner as it would any other sales-type lease.

#### **Scenario 2: Acquiree is the lessee**

Assume the same facts as in Scenario 1, except that Company AR is acquiring Lessee LE, rather than Lessor LR. In connection with the acquisition, the lease is legally assigned to AR. The rate implicit in the lease is not readily determinable because AR and LE do not know LR's estimated residual value or LR's initial direct costs. AR's incremental borrowing rate is 7% at the acquisition date.

As part of its acquisition accounting, AR recognizes a lease liability of \$615,018 (the remaining lease payments of \$728,694 discounted at AR's incremental borrowing rate of 7%) and an ROU asset for the same amount. Because the lease is at market terms, there is no adjustment to the ROU asset from the amount of the lease liability. Subsequent to the acquisition date, AR accounts for the lease in the same manner as it would any other finance lease (see section 6.4.1).

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### **11.1.4 Leveraged leases**

11.1.90 Guidance for leveraged leases acquired in a business combination is included in section 7.8.

### **11.1.5 Post-acquisition accounting**

11.1.100 Subsequent to the acquisition date, the acquirer applies the subsequent measurement guidance in Topic 842 to leases acquired in a business combination. The acquirer accounts for any intangible assets associated with the lease in accordance with Topic 350 (goodwill and other intangibles).

11.1.110 Leasehold (or tenant) improvements acquired in a business combination are recognized at fair value and are amortized from the acquisition date over the shorter of the useful life of the leasehold improvements and the remaining 'lease term' (see section 5.3) at the date of acquisition. This includes leasehold improvements that were placed in service by the acquiree after lease commencement (including significantly after lease commencement). 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 (see section 5.2), the lessee amortizes the leasehold improvements to the end of their useful life. [\[805-20-35-6\]](#)



### Question 11.1.220

#### **Acquirer accounting for an operating lease when it is the lessee and is reasonably certain to exercise a lessee purchase option**

#### **How should an acquirer account for a lease that was classified as an operating lease by the acquiree when the acquirer is reasonably certain to exercise a lessee purchase option?**

**Background:** Consider a scenario in which Company AR acquires Lessee LE, which has a lease of equipment from Lessor LR that it appropriately classified pre-acquisition as an operating lease. The acquisition is accounted for as a business combination (rather than an asset acquisition), and the lease is not modified in connection with the acquisition.

The lease includes a lessee purchase option that, before the acquisition, LE concluded it was not reasonably certain to exercise. However, AR remeasures the lease as if it is a new lease at the acquisition date, and determines it *is* reasonably certain to exercise the purchase option. At the acquisition date, the remaining term of the lease is 6 years and the remaining useful life of the equipment is 11 years. [805-20-30-24]

Despite AR's assessment of the purchase option, AR must retain LE's pre-acquisition operating lease classification because the lease is not modified in connection with the business combination; see Note 1 to the table in paragraph 11.1.10.

In this scenario of an acquired *operating* lease in which the acquirer is reasonably certain to exercise an option to purchase the underlying asset, two questions arise.

- Over what period should the cost of the remaining lease payments (6 years' rentals plus purchase option exercise price) be recognized?
- If the cost of the remaining lease payments should be recognized over the remaining useful life of the equipment (11 years), how much (1) lease cost and (2) depreciation of the equipment post-exercise of the purchase option should be recognized?

**Interpretive response:** In the background example, we believe AR should recognize both:

- lease cost over the remaining lease term; and
- depreciation of the owned equipment from the date the equipment is acquired to the end of its useful life.

We do not believe that it would be appropriate to recognize the cost of the remaining lease payments over the remaining lease term only, such that no depreciation is recognized on the owned equipment after the purchase option is exercised.

With respect to recognizing lease cost and depreciation, we are aware of two approaches being applied in practice. Because US GAAP does not provide specific guidance in this regard, in the absence of additional guidance from the

FASB or the SEC staff, we will accept either approach, applied consistently to similar circumstances.

Example 11.1.40 illustrates both approaches. Under either approach:

- the acquisition date measurement of the ROU asset and the lease liability is the same; and
- the lease liability equals \$0 after the purchase option is exercised (and purchase price paid) at the end of Year 6.

### **Approach 1: Straight-line basis**

Under this approach, the acquirer recognizes the cost of the remaining lease payments, including the purchase option exercise price, on a straight-line basis over the remaining useful life of the underlying asset. Using the background example, this means that the acquirer will recognize annual lease cost until the end of Year 6 equal to the remaining lease payments divided by 11 years.

At the end of the lease term (end of Year 6), the remaining carrying amount of the ROU asset will be reclassified to property, plant and equipment. The asset will then be depreciated following the acquirer's normal depreciation policy under Topic 360 (typically, straight-line).

This approach considers the following:

- A straight-line pattern of cost recognition over the entire remaining useful life of the underlying asset (regardless of the fact that for a portion of that period the asset will be leased, and for the remainder it will be owned) is most representative of the pattern in which the acquirer will derive benefit from use of the asset; and
- This cost recognition pattern (straight-line over 11 years) is consistent with the lease's continued classification post-acquisition as an operating lease, for which the total lease cost (the sum of the rental payments and the purchase option exercise price) is generally recognized on a straight-line basis.

### **Approach 2: As-if finance lease**

Under this approach, the acquirer allocates the remaining lease payments as of the acquisition date between (1) lease cost and (2) depreciation as follows.

- Depreciation is calculated based on what the carrying amount of the ROU asset would be at the purchase option exercise date if the lease were reclassified as a finance lease from the acquisition date; and
- The lease cost is the difference between the remaining lease payments and depreciation.

As in Approach 1, the carrying amount of the ROU asset at the end of the lease term will be reclassified to property, plant and equipment when the purchase option is exercised. The asset will then be depreciated following the acquirer's normal depreciation policy under Topic 360 (typically, straight-line).

The lease cost is recognized on a straight-line basis over the remaining lease term from the acquisition date (6 years in the background example).

This approach considers that there are economic differences between the periods subject to lease and the periods after the lease term when the acquirer

owns the asset, so that equal, straight-line cost each period throughout both may not be appropriate. Total lease cost and depreciation calculated based on what would result from the 'financed purchase' (i.e. finance lease) model in a non-business combination scenario more appropriately reflects those economic differences. Periodic lease cost during the lease term generally should exceed periodic depreciation once the asset is owned because of the interest cost element of the lease.

### Comparing the two approaches

The following are the key practical differences between the approaches.

- Approach 2 will generally result in greater lease cost (cost recognized over the remaining lease term), and less depreciation (after the purchase option is exercised) than Approach 1. The greater ROU asset and property, plant and equipment carrying amounts throughout the remaining useful life of the asset under Approach 1 may result in a greater likelihood of impairment under Topic 360.
- Approach 2 may be more complex to apply than Approach 1. This is because it requires consideration of the accounting that would result from finance lease classification, even though the lease will not be accounted for as a finance lease.



#### Example 11.1.40

#### **Accounting for an acquired lease (operating lease) when the acquirer is reasonably certain to exercise a lessee purchase option**

Company AR acquires Lessee LE, which leases equipment from Lessor LR. The acquisition is accounted for as a business combination. LE appropriately identified the lease and classified it as an operating lease before the acquisition date, and the lease is not modified in connection with the business combination other than AR becoming the legal counterparty to the lease. The terms of the lease are considered at market as of the acquisition date.

At the acquisition date, AR remeasures the lease as if it is a new lease from the acquisition date. AR concludes that it is reasonably certain to exercise the lessee option to purchase the underlying asset at the end of the non-cancellable lease term.

The following additional facts about the underlying lease at the acquisition date are relevant.

Remaining contractual lease term:	6 years
Remaining useful life of equipment:	11 years
Remaining rent payments:	Fixed payments of \$50,000 per year in arrears
Renewal options:	None
Lessee purchase option:	\$140,000 at the end of the contractual lease term
AR's incremental borrowing rate:	5% (the rate implicit in the lease cannot be readily determined)

## Initial measurement

Because the lease was not modified in connection with the business combination, AR does not reassess whether the arrangement is a lease, and retains LE's operating lease classification even though AR is reasonably certain to exercise the lessee option to purchase the equipment at the end of the lease.

At the acquisition date, the remaining lease payments are \$440,000: remaining rent payments ( $\$50,000 \times 6$ ), plus purchase option exercise price (\$140,000).

The remaining lease payments are discounted at AR's incremental borrowing rate of 5% to measure the acquisition date lease liability. Because the lease is at market, the ROU asset equals the lease liability at the acquisition date.

Lease liability:	\$358,254
ROU asset:	\$358,254
Intangible assets (associated with the lease):	None

## Subsequent accounting

### Approach 1: Straight-line basis

The following table shows AR's accounting for the lease through the end of the lease term (i.e. through the end of Year 6 post-acquisition).

Year	ROU asset amortization			ROU asset carrying amount			Lease liab. ending balance <sup>3</sup>
	Single lease cost <sup>1</sup>	Lease liab. accret.	ROU asset amort. <sup>2</sup>	Beg. balance	ROU asset amort.	End. balance	
1	\$40,000	\$17,913	\$22,087	\$358,254	(\$22,087)	\$336,167	\$326,167
2	40,000	16,308	23,692	336,167	(23,692)	312,475	292,475
3	40,000	14,624	25,376	312,475	(25,376)	287,099	257,099
4	40,000	12,855	27,145	287,099	(27,145)	259,954	219,954
5	40,000	10,998	29,002	259,954	(29,002)	230,952	180,952
6	40,000	9,048	30,952	230,952	(30,952)	200,000	-

Notes:

1. Lease payments of \$440,000 / 11 years = \$40,000.
2. Single lease cost – lease liability accretion.
3. Prior ending balance + lease liability accretion – \$50,000 annual rent payment. In Year 6, the lease liability is also reduced by payment of the purchase option exercise price of \$140,000.

At the end of Year 6 when AR exercises the purchase option, AR reclassifies the carrying amount of the ROU asset (\$200,000) to property, plant and equipment. AR depreciates the owned equipment on a straight-line basis (consistent with its policy for other similar assets) over its 5-year remaining useful life. There is no lease liability from the end of Year 6 onward.

The following table shows AR's accounting for the equipment through the end of its useful life; there is no impairment or change in the equipment's estimated useful life.

Year	Depn. expense	PP&E carrying amount		
		Beg. balance	PP&E depn.	End. balance
7	\$40,000	\$200,000	(\$40,000)	\$160,000
8	40,000	160,000	(40,000)	120,000
9	40,000	120,000	(40,000)	80,000
10	40,000	80,000	(40,000)	40,000
11	40,000	40,000	(40,000)	-

### Approach 2: As-if finance lease

In the following steps, AR calculates the end of Year 6 carrying amount of the ROU asset as if the lease were accounted for as a new finance lease from the acquisition date.

1. Calculate the annual finance lease ROU amortization.	\$358,254 acquisition date ROU asset / 11-year remaining useful life of equipment = \$32,568.54 <sup>1</sup>
2. Multiply that amount by the 5-year useful life that will remain after the end of the 6-year contractual lease term.	\$32,568.54 × 5 years = \$162,843
3. Subtract Step 2 amount from the remaining lease payments to arrive at the lease cost to be recognized in Years 1–6 post-acquisition.	\$440,000 – \$162,843 = \$277,157
Note:	
1. This result is shown in greater precision so that subsequent calculations and tables are mathematically accurate.	

The following table shows AR's accounting for the lease through the end of the lease term (i.e. through the end of Year 6 post-acquisition).

Year	ROU asset amortization			ROU asset carrying amount			Lease liab. ending balance <sup>3</sup>
	Single lease cost <sup>1</sup>	Lease liab. accret.	ROU asset amort. <sup>2</sup>	Beg. balance	ROU asset amort.	End. balance	
1	\$46,193	\$17,913	\$28,280	\$358,254	(\$28,280)	\$329,974	\$326,167
2	46,193	16,308	29,885	329,974	(29,885)	300,089	292,475
3	46,193	14,624	31,569	300,089	(31,569)	268,520	257,099
4	46,193	12,855	33,338	268,520	(33,338)	235,182	219,954
5	46,193	10,998	35,195	235,182	(35,195)	199,987	180,952
6	46,192	9,048	37,144	199,987	(37,144)	162,843	-

## Notes:

1. \$277,157 / 6-year contractual term.
2. Single lease cost – lease liability accretion.
3. Prior ending balance + lease liability accretion – \$50,000 annual rent payment. In Year 6, the lease liability is also reduced by payment of the purchase option exercise price of \$140,000.

At the end of Year 6 when AR exercises the purchase option, AR reclassifies the carrying amount of the ROU asset (\$162,843) to property, plant and equipment. AR depreciates the owned equipment on a straight-line basis (consistent with its policy for other similar assets) over its 5-year remaining useful life. There is no lease liability from the end of Year 6 onward.

The following table shows AR's accounting for the equipment through the end of its useful life; there is no impairment or change in the equipment's estimated useful life.

Year	Depn. expense	PP&E carrying amount		
		Beg. balance	PP&E depn.	End. balance
7	\$32,569	\$162,843	\$(32,569)	\$130,274
8	32,569	130,274	(32,569)	97,705
9	32,569	97,705	(32,569)	65,136
10	32,568	65,136	(32,568)	32,568
11	32,568	32,568	(32,568)	-



### Question 11.1.230

#### (Un)favorable contract (liabilities) assets for contracts not accounted for as leases before a modification

#### How should a lessee account for a favorable (unfavorable) contract asset (liability) when a non-lease contract is reassessed as a lease?

**Background:** Assume that Company AR acquired Company AE. As part of AR's acquisition accounting, it recorded a favorable contract intangible asset or an unfavorable contract liability for an existing service contract for which AE was the customer and had appropriately determined the contract was not a lease.

After the acquisition, the terms and conditions of the acquired contract are modified (and the modification does not qualify to be accounted for as a separate contract). On reassessment, based on the changed terms and conditions of the contract, and the facts and circumstances as of the effective date of the modification, the contract meets the definition of a lease.

At the reassessment date, the question arises about how to account for the remaining favorable contract intangible asset or unfavorable contract liability,

given that lessees no longer recognize either for leases after the adoption of Topic 842 (see paragraph 11.1.10).

**Interpretive response:** We believe the lessee should derecognize the existing contract asset (liability) at the effective date of the modification with a corresponding adjustment to the new ROU asset.



## Comparison to legacy US GAAP

### Acquired operating leases where the acquiree is a lessee

11.1.120 Under Topic 805 (pre-amendment), an asset or a liability was recognized in a business combination only to the extent that the operating lease was favorable or unfavorable to market terms. In contrast, under Topic 805 (as amended), the acquirer recognizes a lease liability and an ROU asset for acquired operating leases. The ROU asset is adjusted for favorable or unfavorable terms at the acquisition date. [805-20-25-12]

11.1.130 The acquirer's measurement of any favorable/unfavorable adjustment to the ROU asset under Topic 805 (as amended) will likely be similar to an acquirer's measurement of any favorable lease asset or unfavorable lease liability under Topic 805 (pre-amendment). Consequently, the net effect of this change on the amount of goodwill (or bargain purchase gain) resulting from an acquisition may not be significant.

### Acquired finance (capital) lease assets and lease liabilities no longer measured at fair value

11.1.140 Topic 805 (pre-amendment) generally required the recognition of lease assets and lease liabilities related to capital (sales-type/direct financing) leases at fair value, regardless of whether the acquiree was a lessee or a lessor. In contrast, Topic 805 (as amended) prescribes the measurement of lease assets and lease liabilities on a basis other than fair value. [805-20-30-12(h), 30-24 – 30-25]

11.1.150 It is unclear how significant the financial statement effect of this difference in measurement will be; the basis for conclusions states that the prescribed measurement "will approximate fair value." However, eliminating the requirement to account for finance (sales-type/direct financing) lease assets and lease liabilities at fair value may simplify the acquisition accounting for such leases compared to Topic 805 (pre-amendment). [ASU 2016-02.BC416–BC417]

### Consideration of lease terms and conditions in determining the fair value of lease assets in an acquired sales-type/direct financing lease

11.1.160 Topic 805 (pre-amendment), unlike Topic 805 (as amended), did not explicitly require consideration of the terms and conditions of the lease when measuring the lessor's lease receivable or unguaranteed residual asset. However, in practice before ASU 2016-02, measurement of the lease receivable and the unguaranteed residual asset at fair value would usually take into consideration the terms and conditions of the lease.

**Acquired operating leases where the acquiree is a lessor**

11.1.170 An acquirer's accounting for an acquired operating lease as a lessor in acquisition accounting under Topic 805 (as amended) is substantially unchanged from Topic 805 (pre-amendment).

**Acquired leasehold improvements**

11.1.180 An acquirer's accounting for acquired leasehold improvements under Topic 805 (as amended) is substantially unchanged from Topic 805 (pre-amendment).

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# 12. Disclosures

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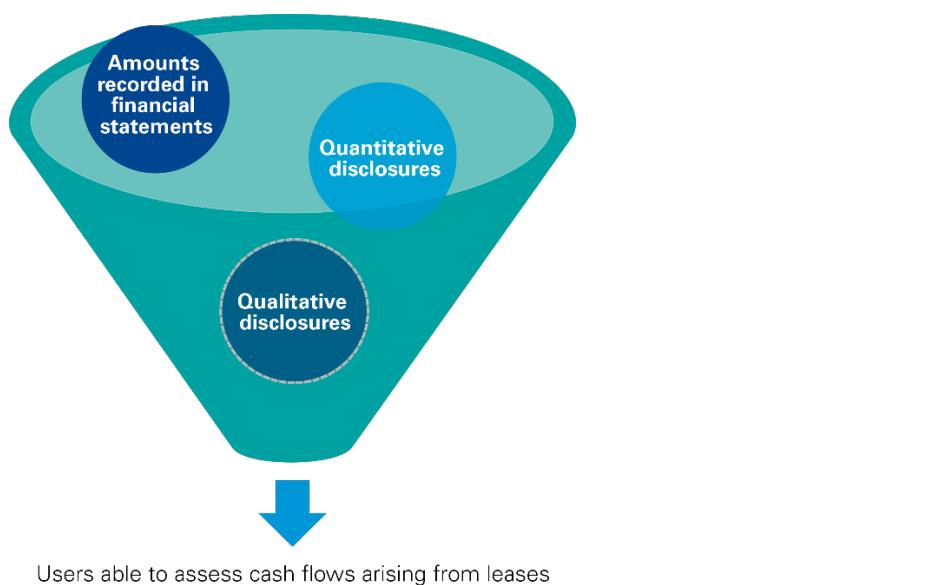
##### Example

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##### Comparison to legacy US GAAP

## How the standard works

The disclosure objective in Topic 842 is to provide financial statement users sufficient information to assess the amount, timing and uncertainty of cash flows arising from leases. To achieve that objective, lessees and lessors disclose qualitative and quantitative information about lease transactions.



This generally will result in increased information being disclosed as compared to Topic 840. Accordingly, entities will need to evaluate whether they have appropriate systems, processes and internal controls to capture the complete and accurate lease data necessary to prepare the financial statement notes.

For a discussion of transition disclosures, see section 13A.2.5 (if electing the effective date transition method) or 13B.2.5 (if electing the comparative transition method).

## 12.1 General disclosure requirements



### Excerpt from ASC 842-20

#### 50 Disclosure

##### General

**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 50-10)
- 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.



### Excerpt from ASC 842-30

#### 50 Disclosure

##### General

**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 **lessor** shall disclose qualitative and quantitative information about all of the following:

- a. Its leases (as described in paragraphs 842-30-50-3(a), 842-30-50-4, and 842-30-50-7)
- b. The significant judgments made in applying the requirements in this Topic to those leases (as described in paragraph 842-30-50-3(b))
- 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).

**50-2** 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.



## Excerpt from ASC 842-40

### 50 Disclosure

#### General

**50-1** If a seller-lessee or a buyer-lessor enters into a sale and leaseback transaction that is accounted for in accordance with paragraphs 842-40-25-4 and 842-40-30-1 through 30-3, it shall provide the disclosures required in paragraphs 842-20-50-1 through 50-10 for a seller-lessee or paragraphs 842-30-50-1 through 50-13 for a buyer-lessor.

**50-2** In addition to the disclosures required by paragraphs 842-20-50-1 through 50-10, a seller-lessee that enters into a sale and leaseback transaction shall disclose both of the following:

- a. The main terms and conditions of that transaction
- b. Any gains or losses arising from the transaction separately from gains or losses on disposal of other assets.

12.1.10 Topic 842 is silent about whether each disclosure requirement should be provided in all circumstances. However, the basis for conclusions highlights that it is implicit to the overall disclosure objective that the level of detail used in the notes should reflect the significance of the entity's leasing activity. As an entity's leasing activities become more significant, the disclosures will be more comprehensive. [\[ASU 2016-02.BC272-BC276\]](#)

12.1.20 In a sale-leaseback transaction for which the asset transfer qualifies as a sale (see chapter 9): [\[842-40-50-1\]](#)

- the seller-lessee provides all applicable disclosures required for a lessee (see section 12.2); and
- the buyer-lessor provides all applicable disclosures required for a lessor (see section 12.3).

12.1.25 Topic 842 does not include disclosure requirements for deferred tax assets and liabilities arising from leases. Topic 740 (income taxes) governs their disclosure. See Question 10.1.05 and chapter 9 of KPMG Handbook, [Accounting for income taxes](#).



## Question 12.1.10

### Interim disclosure requirements

**Are the Topic 842 lease disclosures required for both interim and annual financial reporting periods *after* the year of adoption?**

**Background:** Paragraph 842-20-50-4, which provides for a number of lessee disclosure requirements, states that specified quantitative disclosures should be made for *each period* presented in the financial statements.

**Interpretive response:** No. The only disclosure requirement that applies to all interim periods is for *lessors* to disclose a table of lease income recognized during the period (see section 12.3 and Example 12.3.10). There are no lessee disclosures that are required for interim periods under Topic 842. However, the need for additional interim disclosures should be evaluated under the requirements of Topic 270. [842-30-50-5]

See Question 12.1.20 for additional disclosure guidance for SEC registrants in the year of adoption.

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## Question 12.1.20

### Annual disclosures in interim filings in the year of adoption

**Are registrants required to provide all annual lease disclosures for each interim period in the year of adoption?**

**Interpretive response:** Yes. While Topic 842 only requires certain lessor disclosures be made in all interim financial statements (see Question 12.1.10), Article 10 of Regulation S-X requires SEC registrants to provide both the annual and interim disclosures in each quarterly report in the year of adoption of a new accounting standard – i.e. the first, second and third quarter Form 10-Q filings. [Reg S-X, Article 10, FRM 1500]

Specifically, Article 10 of Regulation S-X requires disclosures about material matters that were not disclosed in the most recent annual financial statements. Therefore, when a registrant adopts a new accounting standard in an interim period (which includes the initial interim period of a fiscal year – e.g. as of the beginning of the first quarter of the fiscal year), it is expected to provide both the annual and the interim period financial statement disclosures prescribed by the new accounting standard, to the extent they are not duplicative with other disclosures. [Reg S-X, Article 10, FRM 1500]

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## Observation

### Overall disclosure objective to guide preparers

12.1.30 The Board included a disclosure objective in the standard so that entities understand the purpose of the disclosure requirements, and to assist entities in determining the extent of information to disclose about leases.  
[IASU 2016-02.BC273]



## Observation

### No specific guidance on disaggregation

12.1.40 Topic 606 explicitly requires entities to disaggregate revenue recognized from contracts with customers into categories that depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. It also provides implementation guidance to assist in selecting the categories for disaggregation. [606-10-50-5, 55-2 – 55-91]

12.1.50 While Topic 842 requires entities to consider the appropriate level of detail and aggregation for its lease disclosures, the Board decided not to provide specific quantitative or qualitative disaggregation requirements such as those required of entities about their contracts with customers under Topic 606.

12.1.60 However, the FASB staff, during deliberations of the disclosure proposals, provided examples of possible categories they believe qualitative lease disclosure information *could* be disaggregated into to satisfy the disclosure objective, including the following (not exhaustive).

- Class of underlying asset.
- Business segment or unit in which the leased asset is used.
- Lease term – e.g. 3–5 year leases, 6–9 year leases and leases longer than 10 years.
- Lease payment terms – e.g. those with solely or principally fixed lease payments versus those with significant variable lease payments, or those that are prepaid.
- Geographical region in which the lease was entered into and/or in which the leased asset will be used.

## 12.2 Lessee disclosures



### Excerpt from ASC 842-20

#### 50 Disclosure

##### General

**50-3** A lessee shall disclose all of the following:

- a. Information about the nature of its leases, including:

1. A general description of those leases.
2. The basis and terms and conditions on which **variable lease payments** are determined.
3. The existence and terms and conditions of options to extend or terminate the lease. A lessee should provide narrative disclosure about the options that are recognized as part of its **right-of-use assets** and **lease liabilities** and those that are not.
4. The existence and terms and conditions of **residual value guarantees** provided by the lessee.
5. The restrictions or covenants imposed by leases, for example, those relating to dividends or incurring additional financial obligations.

A lessee should identify the information relating to **subleases** included in the disclosures provided in (1) through (5), as applicable.

- b. Information about leases that have not yet commenced but that create significant rights and obligations for the lessee, including the nature of any involvement with the construction or design of the **underlying asset**.
- c. Information about significant assumptions and judgments made in applying the requirements of this Topic, which may include the following:
  1. The determination of whether a **contract** contains a lease (as described in paragraphs 842-10-15-2 through 15-27)
  2. The allocation of the consideration in a contract between lease and nonlease components (as described in paragraphs 842-10-15-28 through 15-32)
  3. The determination of the **discount rate for the lease** (as described in paragraphs 842-20-30-2 through 30-4).

**50-4** For each period presented in the financial statements, a lessee shall disclose the following amounts relating to a lessee's total lease cost, which includes both amounts recognized in profit or loss during the period and any amounts capitalized as part of the cost of another asset in accordance with other Topics, and the cash flows arising from lease transactions:

- a. **Finance lease** cost, segregated between the amortization of the right-of-use assets and interest on the lease liabilities.
- b. **Operating lease** cost determined in accordance with paragraphs 842-20-25-6(a) and 842-20-25-7.
- c. **Short-term lease** cost, excluding expenses relating to leases with a **lease term** of one month or less, determined in accordance with paragraph 842-20-25-2.
- d. Variable lease cost determined in accordance with paragraphs 842-20-25-5(b) and 842-20-25-6(b).
- e. Sublease income, disclosed on a gross basis, separate from the finance or operating lease expense.
- f. Net gain or loss recognized from sale and leaseback transactions in accordance with paragraph 842-40-25-4.
- g. Amounts segregated between those for finance and operating leases for the following items:
  1. Cash paid for amounts included in the measurement of lease liabilities, segregated between operating and financing cash flows
  2. Supplemental noncash information on lease liabilities arising from obtaining right-of-use assets

3. Weighted-average remaining lease term
4. Weighted-average discount rate.

**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.

**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.

**50-7** A lessee shall disclose lease transactions between related parties in accordance with paragraphs 850-10-50-1 through 50-6.

**50-7A** When the **useful life** of leasehold improvements to the common control group determined in accordance with paragraph 842-20-35-12A exceeds the related lease term, a lessee shall disclose the following information:

- a. The unamortized balance of the leasehold improvements at the balance sheet date
- b. The remaining useful life of the leasehold improvements to the common control group
- c. The remaining lease term.

**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.

**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.

**50-10** A lessee that makes the accounting policy election in paragraph 842-20-30-3 to use a risk-free rate as the discount rate shall disclose its election and the class or classes of underlying assets to which the election has been applied.

## 55 Implementation Guidance and Illustrations

### General

- > Implementation Guidance
- > 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.

**55-12** The lessee should calculate the weighted-average discount rate on the basis of both of the following:

- a. The **discount rate for the lease** that was used to calculate the lease liability balance for each lease as of the reporting date
- b. The remaining balance of the **lease payments** for each lease as of the reporting date.

> Illustrations

- > 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.

	<b>Year Ending December 31,</b>	
	<b>20X2</b>	<b>20X1</b>
Lease cost		
Finance lease cost:	\$XXX	\$XXX
Amortization of right-of-use assets	XXX	XXX
Interest on lease liabilities	XXX	XXX
Operating lease cost	XXX	XXX
Short-term lease cost	XXX	XXX
Variable lease cost	XXX	XXX
Sublease income	(XXX)	(XXX)
Total lease cost	\$XXX	\$XXX
Other information		
(Gains) and losses on sale and leaseback transactions, net	\$(XXX)	\$XXX
Cash paid for amounts included in the measurement of lease liabilities	XXX	XXX
Operating cash flows from finance leases	XXX	XXX
Operating cash flows from operating leases	XXX	XXX
Financing cash flows from finance leases	XXX	XXX
Right-of-use assets obtained in exchange for new finance lease liabilities	XXX	XXX
Right-of-use assets obtained in exchange for new operating lease liabilities	XXX	XXX

Weighted-average remaining lease term—finance leases	X.X years	X.X years
Weighted-average remaining lease term—operating leases	X.X years	X.X years
Weighted-average discount rate—finance leases	X.X%	X.X%
Weighted-average discount rate—operating leases	X.X%	X.X%

## 12.2.1 Qualitative and quantitative information

12.2.10 Finance and operating lease liabilities are either presented separately on the balance sheet or disclosed separately in the notes to the financial statements. [842-20-45-1]

12.2.20 When making disclosures related to leases with related parties, lessees should also comply with the relevant disclosure requirements in Topic 850 (related party disclosures). [850-10-50-1 – 50-6]

12.2.30 Although the Board provided a list of qualitative and quantitative disclosures, a lessee may need to provide additional information about its leases to achieve the disclosure objective (see paragraph 12.1.30). For example, a lessee will need to consider whether to disclose information about reassessments or modifications that occurred during the reporting period, such as the following.

Disclosure	Required for:	
	Reassessments	Modifications
Lessee action(s) that triggered a reassessment of the lease term or exercise of purchase option(s).	✓	
The existence, and terms and conditions, of contract modifications.		✓
Whether a contract modification was accounted for as a separate contract and any significant judgments made in that determination.		✓
Reallocation of the remaining contract consideration to the lease components and non-lease components.	✓	✓ <sup>(1)</sup>
If the lease classification changes, that fact and how it affects the comparative periods presented – e.g. amounts recognized in the income statement, and in the statement of cash flows.	✓	✓ <sup>(1)</sup>

Disclosure	Required for:	
	Reassessments	Modifications
The effect on the measurement of the lease liability, ROU asset and any amounts recognized in the income statement.	✓	✓ <sup>(1)</sup>

Note:

- When the lease modification is not accounted for as a separate contract.

### Observation Quantitative information in lieu of a lease liability rollforward

12.2.40 Earlier drafts of the new leasing guidance proposed to require lessees to rollforward, using a tabular reconciliation, their lease liabilities each period. The Board decided not to require a reconciliation of the opening and closing balances of lease liabilities in Topic 842 due to preparers' concerns about the costs and complexity of implementation.

12.2.50 Some preparers cited the need for more robust IT systems and/or process capabilities to track and accumulate reconciling items that were not required under Topic 840. Instead, the Board decided to require lessees to disclose those components of the reconciliation that they identify as most important to financial statement users, including total lease cost and cash paid for amounts included in the measurement of lease liabilities. The Board decision not to require a lease liability rollforward (or reconciliation) is consistent with current US GAAP for other financial liabilities, which does not require a reconciliation. [\[ASU 2016-02 BC284-BC286\]](#)

### Question 12.2.05 Incremental borrowing rate disclosures

#### What should a lessee disclose about how it determines its incremental borrowing rate?

**Background:** Lessees are required to make disclosures about how they determine the discount rate for their leases, including the related assumptions and judgments, which will generally be the lessee's incremental borrowing rate (see Question 5.6.20). [\[842-20-50-3\(c\)\(3\)\]](#)

**Interpretive response:** If lease discount rates are material to the lessee's financial reporting, we believe the lessee should provide information relevant to how the rates reflected in the measurement of its leases were determined. We do not believe generic disclosures that, in effect, merely repeat the Topic 842 incremental borrowing rate definition will satisfy the disclosure requirement.

The lessee's disclosure may include information about what inputs it used, and what adjustments it made to those inputs, in estimating the incremental borrowing rates. And if the lessee is using a portfolio approach in determining those rates, or has a significant number of leases for which the rate reflects the incremental borrowing rate of the parent or group, rather than the legal entity (e.g. subsidiary) entering into the lease with the lessor, likely those facts should be disclosed as well.



### Question 12.2.10

#### **Supplemental disclosure of noncash leasing activities – lessees**

#### **Are lessees required to disclose all changes to ROU assets and lease liabilities that arise from noncash activities?**

**Background:** The lessee disclosure requirements in Topic 842 only explicitly require lessees to disclose supplemental noncash information about 'lease liabilities arising from obtaining ROU assets'. [842-20-50-4(g)(2), 55-53]

Some stakeholders, in evaluating this question have asked whether:

- the disclosure requirement in Topic 842 also applies to increases in the lessee's ROU assets and lease liabilities resulting from remeasurements or modifications that do not involve obtaining a new ROU asset – e.g. obtaining a new right to use an additional asset; and
- supplemental noncash disclosures must be provided for activities that decrease the lessee's ROU assets and lease liabilities – e.g. remeasurements or modifications.

The following table lists events whose occurrence could change the carrying amount of recognized ROU assets and lease liabilities without an expenditure or receipt of cash by the lessee (not exhaustive).

Event	Increase to ROU asset and lease liability	Decrease to ROU asset <sup>1</sup> and lease liability
Modifications accounted for as a separate contract (see paragraphs 6.7.30 – 6.7.40)	✓	
Modifications granting the lessee an additional right of use, but not accounted for as a separate contract	✓	
Modifications that change the terms of an existing lease – e.g. change the lease term, add/remove a lessee purchase option or change the terms of a residual value guarantee	✓	✓

Event	Increase to ROU asset and lease liability	Decrease to ROU asset <sup>1</sup> and lease liability
Modifications that change only the price of an existing lease	✓	✓
Modifications fully or partially terminating a lease – e.g. reducing the amount of space being leased		✓
Remeasurement events (see section 6.6) – e.g. changes to the lease term, the assessment of a lessee purchase option or the amount probable of being owed under a residual value guarantee	✓	✓
Note:		
1. The ROU asset will not be decreased for one of these events if its pre-event carrying amount is already \$0.		

**Interpretive response:** To the extent material, yes. We believe the requirements of Topic 842 and Topic 230 (statement of cash flows), taken together, effectively require supplemental disclosure of all material noncash changes to ROU assets and lease liabilities.

There are differing views as to the extent of the specific Topic 842 requirement to disclose ‘supplemental noncash information on lease liabilities arising from obtaining right-of-use assets’. For example, when considering the background questions, some believe the Topic 842 disclosure requirement applies only to events that result from adding a new ROU asset, while others believe that the disclosure was intended to capture either (1) any increases to ROU assets and lease liabilities or (2) all changes (increases and decreases) in those asset or liability amounts.

Regardless of one’s interpretation of Topic 842, we believe Topic 230, which was not superseded or changed in any way by ASU 2016-02, requires disclosure of information about *all* investing and financing activities of an entity during a period that affect recognized assets or liabilities but do not result in cash receipts or cash payments in the period. Topic 230 does not make a distinction between noncash activities that result in increases or decreases to recognized assets or liabilities. It therefore requires disclosure of *any* noncash changes to ROU assets and lease liabilities that are not required to be disclosed or presented elsewhere in the financial statements by another Topic (e.g. Topic 842). [\[230-10-50-3\]](#)

Consequently, any material noncash leasing activities would need to be disclosed under Topic 230 regardless of whether they are required to be disclosed by Topic 842.

Neither Topic 842 nor Topic 230 specify where in the financial statements the required supplemental noncash disclosures must be made.



## Question 12.2.20 MD&A disclosure of contractual obligations

### Should an SEC registrant's MD&A disclosures about contractual obligations be consistent with the maturity analysis of lease liabilities under Topic 842?

**Background:** In November 2020, the SEC adopted amendments to Regulation S-K to simplify MD&A and other financial disclosures; see KPMG Hot Topic, [SEC amends Regulation S-K to streamline disclosures](#). Among other changes, the amendments to Item 303 eliminated the requirement to tabularly present a registrant's contractual obligations.

The rule amendments became effective on February 10, 2021. Compliance with the amended rules was required beginning with the fiscal year ending on or after August 9, 2021 – e.g. year ending December 31, 2021 for calendar year-end registrants. Early compliance with the Item 303 amendments, in filings made after February 10, 2021, was allowed if a registrant complies with the amended Item in its entirety. [\[Reg S-K Section II.F\]](#)

**Interpretive response:** It depends. Although the amendments to Item 303 eliminate the requirement to tabularly present a registrant's contractual obligations, we believe that lease commitments may still need to be disclosed, if material, in MD&A. The disclosure would be part of the 'enhanced' liquidity and capital resources disclosures called for by the amendments, which include required disclosures of material cash requirements from obligations. [\[Reg S-K Item 303\(b\)\(1\)\]](#)

The enhanced liquidity and capital resources disclosures also appear to require some measure of continued time-banding of material future lease obligations. [\[Reg S-K Item 303\(b\)\(1\)\]](#)

An entity's facts and circumstances will dictate the extent of the lease-related disclosures required. To the extent that contractual commitments related to leases continue to be disclosed, we believe the disclosure should be consistent with the entity's US GAAP footnotes. This comports with guidance in the SEC Staff Financial Reporting Manual related to the previously required contractual obligations table, which stated, when preparing that disclosure, "The information disclosed in the table in respect of long-term debt obligations, capital (finance) leases and operating lease obligations should be consistent with the disclosures provided in the financial statements." [\[FRM 9240.6\(c\)\]](#)



## Example 12.2.10

**Weighted-average remaining lease term disclosure**

A lessee calculates the weighted-average remaining lease term based on the remaining lease term and the lease liability balance for each lease at the reporting date. [842-20-55-11]

For the year ended December 31, 20X1, Lessee LE discloses a weighted-average remaining lease term of 4.96 years for its finance leases, and 2.73 years for its operating leases. LE calculated the weighted-average remaining lease terms as follows.

<b>Lease ID</b>	<b>Lease liab. 12/31/20X1 (A)</b>	<b>Remaining lease term at 12/31/20X1 (B)</b>	<b>(A × B)</b>	<b>Weighted- avg. lease term at 12/31/20X1</b>
<b>Finance leases</b>				
FL1	\$ 52,936	4.00	211,744	
FL2	94,499	5.50	519,745	<b>D/C</b>
	<b>C = \$147,435</b>		<b>D = 731,489</b>	<b>4.96</b>
<b>Operating leases</b>				
OL1	\$ 14,104	2.00	28,208	
OL2	21,654	2.25	48,722	
OL3	33,570	2.54	85,268	
OL4	24,365	4.00	97,460	
OL5	12,847	2.42	31,090	<b>F/E</b>
	<b>E = \$106,540</b>		<b>F = 290,748</b>	<b>2.73</b>



## Example 12.2.20

**Weighted-average discount rate disclosure**

A lessee calculates the weighted-average discount rate based on: [842-20-55-12]

- the discount rate for the lease – i.e. used to calculate the lease liability balance for each lease at the reporting date; and
- the remaining balance of the lease payments for each lease at the reporting date.

For the year ended December 31, 20X1, Lessee LE discloses a weighted-average discount rate of 5.72% for its finance leases, and 4.29% for its operating leases. The leases described are the same as in Example 12.2.10. LE calculated the weighted-average discount rates as follows.

Lease ID	Remaining pmts. 12/31/20X1 (A)	Rate to calc. liabs. (B)	(A x B)	Weighted- avg. discount rate 12/31/20X1
<b>Finance leases</b>				
FL1	\$ 60,000	5.20%	3,120	
FL2	112,500	6.00%	6,750	<b>D/C</b>
	<b>C = \$172,500</b>		<b>D = 9,870</b>	<b>5.72%</b>
<b>Operating leases</b>				
OL1	\$ 15,000	4.20%	630	
OL2	22,800	4.20%	958	
OL3	36,000	4.70%	1,692	
OL4	27,000	4.20%	1,134	
OL5	13,500	3.60%	486	<b>F/E</b>
	<b>E = \$114,300</b>		<b>F = 4,900</b>	<b>4.29%</b>



### Example 12.2.30

#### Periodic short-term lease cost does not reasonably reflect lessee's short-term lease commitments

Lessee LE has elected to apply the short-term lease exemption to one of its classes of underlying assets: office equipment (e.g. copiers and printers). In 20X1, LE has only a small number of leases within this class of underlying asset that qualify for the exemption. The short-term lease cost recognized and disclosed for those leases in 20X1 is \$200,000. The remaining lease payments due in 20X2 are \$40,000.

On December 31, 20X1, LE enters into a master lease agreement for a number of new items of office equipment. The leases subject to that agreement qualify as short-term leases because the non-cancellable period of the leases is one year, and LE is not reasonably certain to exercise its right to renew those leases at the end of the non-cancellable period – i.e. the lease term is one year or less.

Because LE has elected the short-term lease exemption for its leases of office equipment, the exemption applies to these new office equipment leases. The total lease payments that will be paid in 20X2 for the additional items of office equipment are \$2,400,000.

In accordance with the lessee disclosure requirements in Topic 842, LE discloses the following in the notes to its 20X1 financial statements:

- the fact that it elected to apply the short-term lease exemption for its leases of office equipment;
- short-term lease cost of \$200,000 in 20X1; and

- because the periodic short-term lease cost of \$200,000 disclosed does not reasonably reflect the lessee's short-term lease commitments as of December 31, 20X1, that fact, and the amount of its short-term lease commitments of \$2,440,000 (\$2,400,000 + \$40,000).



## Comparison to legacy US GAAP

### Increased qualitative and quantitative disclosures

12.2.60 Lessee disclosures under Topic 842 are more extensive than those under Topic 840. [840-10-50, 840-20-50, 840-30-50, 840-40-50]

- Examples of new qualitative disclosures include (1) information about leases that have not yet commenced at the reporting date that create significant rights and obligations to the lessee, and (2) significant judgments made, such as determining whether a contract contains a lease, determining the discount rate for the lease, and allocating the consideration in the contract to lease and non-lease components.
- Examples of new quantitative disclosures include cash paid for amounts included in the measurement of lease liabilities, supplemental non-cash information on lease liabilities arising from obtaining ROU assets for operating leases, weighted-average remaining lease terms, and weighted-average discount rate information.

## 12.3 Lessor disclosures



### Excerpt from ASC 842-30

#### 50 Disclosure

##### General

**50-3** A lessor shall disclose both of the following:

- Information about the nature of its leases, including:
  - A general description of those leases
  - The basis and terms and conditions on which **variable lease payments** are determined
  - The existence and terms and conditions of options to extend or terminate the lease
  - The existence and terms and conditions of options for a **lessee** to purchase the **underlying asset**.
- Information about significant assumptions and judgments made in applying the requirements of this Topic, which may include the following:
  - 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**.

**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).

**50-4** A lessor shall disclose any lease transactions between related parties (see Topic 850 on related party disclosures).

**50-5** A lessor shall disclose lease income recognized in each annual and interim reporting period, in a tabular format, to include the following:

- a. For **sales-type leases** and **direct financing leases**:
  1. Profit or loss recognized at the **commencement date** (disclosed on a gross basis or a net basis consistent with paragraph 842-30-45-4)
  2. Interest income either in aggregate or separated by components of the **net investment in the lease**.
- b. For **operating leases**, lease income relating to **lease payments**.
- c. Lease income relating to variable lease payments not included in the measurement of the **lease receivable**.

**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).

**50-7** A lessor shall disclose information about how it manages its risk associated with the residual value of its leased assets. In particular, a lessor should disclose all of the following:

- a. Its risk management strategy for residual assets
- b. The carrying amount of residual assets covered by **residual value guarantees** (excluding guarantees considered to be lease payments for the lessor, as described in paragraph 842-30-30-1(a)(2))

- c. Any other means by which the lessor reduces its residual asset risk (for example, buyback agreements or variable lease payments for use in excess of specified limits).

> Sales-Type and Direct Financing Leases

**50-8** In addition to the disclosures required by paragraphs 842-30-50-3 through 50-7, a **lessor** also shall provide the disclosures in paragraphs 842-30-50-9 through 50-10 for **sales-type leases** and **direct financing leases**.

**50-9** A lessor shall explain significant changes in the balance of its **unguaranteed residual assets** and deferred selling profit on direct financing leases.

**50-10** A lessor shall disclose a maturity analysis of its **lease receivables**, showing the undiscounted cash flows to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. A lessor shall disclose a reconciliation of the undiscounted cash flows to the lease receivables recognized in the statement of financial position (or disclosed separately in the notes).

> Operating Leases

**50-11** In addition to the disclosures required by paragraphs 842-30-50-3 through 50-7, a **lessor** also shall provide the disclosures in paragraphs 842-30-50-12 through 50-13 for **operating leases**.

**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**.

**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.

> Separating Components of a Contract

**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.

12.3.10 Lessor disclosure requirements for grandfathered leveraged leases are discussed in section 7.8.



### Example 12.3.10

#### Chart of lease income for the reporting period

The following chart is an example of the lease income disclosure by Lessor LR, which is required to be in tabular format and is required to be provided in both annual *and* interim periods (see Question 12.1.10).

For the years ended December 31 (in thousands)	20X9	20X8
Lease income – sales-type and direct financing leases		
Profit at lease commencement <sup>1</sup>	\$ 17	\$ 5
Interest income on lease receivables <sup>2</sup>	345	320
Interest income from accretion of unguaranteed residual assets <sup>2</sup>	105	97
<b>Subtotal</b>	<b>467</b>	<b>422</b>
Lease income – operating leases	510	495
Variable lease income	25	22
<b>Total lease income</b>	<b>\$1,002</b>	<b>\$939</b>
Notes:		
1. Presentation is based on LR's business model in accordance with paragraph 842-30-45-4. In this example, LR uses leases for the purpose of providing finance and therefore profit is presented net.		
2. Interest income on LR's net investment in leases may be disclosed either in aggregate or separately (as shown) for each component of the net investment in the lease.		



### Question 12.3.10

#### Assets subject to operating leases as a separate major class of depreciable assets

#### Are assets subject to operating leases a separate major class of depreciable assets?

**Interpretive response:** Yes. A lessor should treat assets subject to operating leases as a separate major class of depreciable assets, which should be further disaggregated by significant class of underlying assets (e.g. airplanes versus buildings).

In the Board's view, leased assets are often subject to risks different from owned assets that are held and used by the entity, and providing separate disclosures related to those assets benefits users. In addition, the risks related to one class of leased asset may be very different from another such that additional disaggregation by class of underlying asset is appropriate.

[ASU 2016-02, BC341]



## Question 12.3.20

**Separate disclosure of tenant reimbursements****Is a lessor that elected the lessor non-separation practical expedient permitted to separately disclose tenant reimbursements?**

**Background:** Under Topic 840, lessors (particularly real estate lessors) frequently adopted a practice for net leases (see paragraph 7.3.170) of presenting separately:

- revenue from the base rental payments due under a lease; and
- tenant reimbursements of lessor executory costs such as property taxes, insurance and maintenance (including common area maintenance).

As explained in Question 7.7.30, it is not acceptable for a lessor that has elected the non-separation practical expedient for lease and non-lease components (see paragraphs 4.4.51 – 4.4.57) to present these tenant reimbursements separately from base rental revenue in its income statement.

Consequently, the question arises as to whether it is acceptable for the lessor to disclose the amount of tenant reimbursements it has included within lease revenue. For example, if a lessor recognizes lease revenue of \$100 for the period, is it permitted to disclose that \$16 of the \$100 is related to tenant reimbursements?

**Interpretive response:** In general, yes – provided that the lessor does not characterize the tenant reimbursements as a revenue measure, or present them in a manner that suggests they reflect payments for something other than, or in addition to, the right to use the underlying asset.

Therefore, in general, we believe separate presentation of such amounts should be labeled factually (e.g. as 'tenant reimbursements'), and shown and/or discussed as a component of the single income statement line item (i.e. lease revenue) – i.e. as an item that totals to lease revenue. Further, discussion of tenant reimbursements should be limited to disclosing facts, such as the dollar amount of property tax and/or insurance reimbursements billed to lessees that is included in the applicable income statement line item (e.g. lease revenue) for the period.

It would not be appropriate to characterize those amounts as anything other than a component of the single income statement line item. For example, we do not believe tenant reimbursements should be presented in manner that suggests lease revenue or rental revenue includes only the base rent payments.

Doing so might inappropriately suggest a differentiation between the tenant reimbursements and base rent that is inconsistent with the fact that both amounts (the tenant reimbursements and the base rent) reflect payments for the right to use the underlying asset.



## Comparison to legacy US GAAP

### More information on risks to which a lessor is exposed and lease income

12.3.20 Although the Board decided not to substantially change lessor accounting and to retain most of the existing disclosure requirements, its decision to expand the lessor disclosure requirements is intended to provide financial statement users (e.g. investors and analysts) with: [840-10-50, 840-20-50, 840-30-50, 840-40-50]

- more information about the risks to which a lessor is exposed; for example, collectibility of lease receivables (i.e. credit risk), and risks related to the lessor's residual interest in its leased assets; and
- additional information about a lessor's lease income (see Example 12.3.10).

# 13A. Effective dates and transition: effective date method

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#### **13A.1 Effective dates**

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- 13A.3.3 ASU 2021-09, Discount Rate for Lessees That Are Not Public Business Entities
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- 13A.4.3 ASU 2018-20, Narrow-Scope Improvements for Lessors
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### **Question**

13A.6.10 Acquired leveraged leases

## **13A.7 Sale-leaseback transactions**

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## Structure of transition chapters

The discussion of transition has been divided into two separate chapters.

- This chapter discusses the 'effective date method', which is the additional transition method introduced in ASU 2018-11.
- Chapter 13B discusses the 'comparative method', which is the original transition method introduced in ASU 2016-02.

For purposes of comparison, the Question numbers are the same in each chapter. If a question is not applicable to one chapter, that question is indicated as 'Not used' in the 'Detailed contents'.

The guidance that follows in this chapter should be used only by those who elect the effective date method.

## How the standard works

Topic 842 requires entities to use a modified retrospective transition method.

In July 2018, the Board issued ASU 2018-11, which provides an alternative modified retrospective transition method. Under this new method, the cumulative-effect adjustment to the opening balance of retained earnings is recognized on the date of adoption – e.g. January 1, 2019 for calendar year-end public business entities, and January 1, 2022 for private companies, that do not early adopt Topic 842.

<b>Effective date:</b>	Public business entities: <sup>1</sup> Annual and interim periods in fiscal years beginning after December 15, 2018.	Public not-for-profit entities: <sup>2,3</sup> Annual and interim periods in fiscal years beginning after December 15, 2019.	Other entities: <ul style="list-style-type: none"><li>— Annual periods in fiscal years beginning after December 15, 2021.</li><li>— Interim periods in fiscal years beginning after December 15, 2022.</li></ul>
<b>Date of initial application:</b>	The entity's effective date – i.e. the beginning of the reporting period in which Topic 842 is first applied. For a public business entity with a calendar year-end that does not early adopt Topic 842, this date will be January 1, 2019. For a private company with a calendar year-end that does not early adopt Topic 842, this date will be January 1, 2022. The effective date and the date of initial application are the same under the effective date method.		
<b>Early adoption:</b>	All entities can adopt Topic 842 immediately.		
<b>Transition method:</b>	Modified retrospective, which requires a cumulative-effect adjustment to the opening balance of retained earnings on the effective date.		
<b>Package of practical expedients (all or nothing):</b>	An entity may elect not to reassess: <ul style="list-style-type: none"><li>— whether expired or existing contracts contain leases under the new definition of a lease;</li><li>— lease classification for expired or existing leases; and</li><li>— whether previously capitalized initial direct costs would qualify for capitalization under Topic 842.</li></ul>		
<b>Use of hindsight:</b>	<ul style="list-style-type: none"><li>— Hindsight allowed when considering the likelihood that lessee options to extend or terminate a lease or purchase the underlying asset will be exercised.</li><li>— Elect on its own or with the package of practical expedients.</li></ul>		
<b>Land easements:</b>	<ul style="list-style-type: none"><li>— An entity may elect not to assess at transition whether any expired or existing land easements are, or contain, leases if they were not previously accounted for as leases under Topic 840.</li><li>— Elect on its own or with the package of practical expedients and/or hindsight.</li></ul>		

**Notes:**

1. This includes (1) public business entities, (2) public not-for-profit entities not addressed by Note 3, and (3) employee benefit plans that file or furnish financial statements with or to the SEC.
2. 'Public' not-for-profit entities are those that have issued or are conduit bond obligors for securities that are traded, listed or quoted on an exchange or an over-the-counter market.
3. Public not-for-profit entities are eligible to elect this effective date if they did not issue GAAP-compliant financial statements reflecting the adoption of Topic 842 before June 3, 2020 (the issuance date of ASU 2020-05).

## 13A.1 Effective dates



### Excerpt from ASC 842-10

#### 65 Transition and Open Effective Date Information

##### General

> Transition Related to Accounting Standards Updates No. 2016-02, *Leases (Topic 842)*, No. 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*, No. 2018-10, *Codification Improvements to Topic 842, Leases*, No. 2018-11, *Leases (Topic 842): Targeted Improvements*, No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, 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*, No. 2020-05, *Revenue from Contracts with Customers (Topic 606)* and *Leases (Topic 842): Effective Dates for Certain Entities*, No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*, No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*, and No. 2023-01, *Leases (Topic 842): Common Control Arrangements*

**65-1** The following represents the transition and effective date information related to Accounting Standards Updates No. 2016-02, *Leases (Topic 842)*, No. 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*, No. 2018-10, *Codification Improvements to Topic 842, Leases*, No. 2018-11, *Leases (Topic 842): Targeted Improvements*, No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, 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*, No. 2020-05, *Revenue from Contracts with Customers (Topic 606)* and *Leases (Topic 842): Effective Dates for Certain Entities*, No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*, No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*, and No. 2023-01, *Leases (Topic 842): Common Control Arrangements*: [Note: See paragraph 842-10-S65-1 for an SEC Staff Announcement on transition related to Update 2016-02.]

- 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.

> Transition Related to Accounting Standards Update No. 2018-11, *Leases (Topic 842): Targeted Improvements*

**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.

> Transition Related to Accounting Standards Update No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*

**65-3** 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*:

- 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 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 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:

1. In the first reporting period ending after the issuance of the pending content that links to this paragraph
2. In the first reporting period beginning after the issuance of the pending content that links to this paragraph.
- 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:
  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.

> Transition 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*

**65-4** 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. Early 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).

> Transition Related to Accounting Standards Update No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*

**65-5** The following represents the transition and effective date information related to Accounting Standards Update No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*:

- a. An entity that has not yet adopted the pending content that links to paragraph 842-10-65-1 as of July 19, 2021, shall apply the pending content that links to this paragraph when it 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 within the scope of paragraph 842-10-65-1(a) that has adopted the pending content that links to paragraph 842-10-65-1 as of July 19, 2021, shall apply the pending content that links to this paragraph for fiscal years beginning after December 15, 2021, and interim periods within those fiscal years. Earlier application is permitted.
- c. An entity within the scope of paragraph 842-10-65-1(b) that has adopted the pending content that links to paragraph 842-10-65-1 as of July 19, 2021, shall apply the pending content that links to this paragraph for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. Earlier application is permitted.
- d. An entity within the scope of (b) or (c) shall apply the pending content that links to this paragraph by using one of the following two methods:
  1. Retrospectively to the date in which the pending content that links to paragraph 842-10-65-1 was adopted (the beginning of the period of adoption of Topic 842). Under this transition method, the entity shall apply the pending content that links to this paragraph to leases that commence or are modified on or after the beginning of the period of its adoption of Topic 842 and do not meet the conditions in paragraph 842-10-25-8.
  2. Prospectively to leases that commence or are modified on or after the date that the entity first applies the pending content that links to this paragraph and do not meet the conditions in paragraphs 842-10-25-8.
- e. An entity within the scope of (b) or (c) that elects the transition method in (d)(1) shall provide the following transition disclosures:
  1. The applicable 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
  2. The transition disclosures in paragraph 250-10-50-1(b)(3) as of the beginning of the earliest period presented but not before the date in which the pending content that links to paragraph 842-10-65-1 was adopted.
- f. An entity within the scope of (b) or (c) that elects the transition method in (d)(2) shall provide the following transition disclosures:
  1. The nature of and reason for the change in accounting principle
  2. The transition method
  3. A qualitative description of the financial statement line items affected by the change.

> Transition Related to Accounting Standards Update No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*

**65-6** The following represents the transition and effective date information related to Accounting Standards Update No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*:

- a. An entity that has not yet adopted the pending content that links to paragraph 842-10-65-1 as of 11/11/2021, shall apply the pending content that links to this paragraph to all new and existing leases when the entity first applies the pending content that links to paragraph 842-10-65-1. That entity 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 as of 11/11/2021, shall:
  1. 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 as of the beginning of the fiscal year of adoption.
  2. Apply the pending content that links to this paragraph on a modified retrospective basis to leases affected by the amendments existing as of the beginning of the fiscal year of adoption by adjusting the lease liability, which shall be calculated based on the discount rate and remaining lease term at the beginning of the fiscal year of adoption. An entity shall recognize the amount of the change in the lease liability as an adjustment to the corresponding right-of-use asset, unless:
    - i. The carrying amount of the right-of-use asset is reduced to zero, in which case the entity shall recognize any remaining amount of the adjustment to opening retained earnings at the beginning of the fiscal year of adoption.
    - ii. The adjustment would increase a right-of-use asset that was previously impaired, in which case the entity shall record the adjustment to opening retained earnings at the beginning of the fiscal year of adoption.
- c. An entity within the scope of (b) shall not treat the adoption of the pending content that links to this paragraph as an event that would require the entity to:
  1. Remeasure and reallocate the consideration in the contract in accordance with paragraph 842-10-15-36.
  2. Reassess the lease term or a lessee option to purchase the underlying asset in accordance with paragraph 842-10-35-1.
  3. Remeasure the lease payments in accordance with paragraph 842-10-35-4.
  4. Reassess lease classification in accordance with paragraph 842-10-25-1.
- d. An entity within the scope of (b) that has adopted the pending content that links to this paragraph shall disclose the following as of the beginning of the fiscal year of adoption (rather than at the beginning of the earliest period presented):

1. The information required by paragraph 250-10-50-1(a) and (b)(3), if applicable
2. The recognized amount of changes in lease liabilities and corresponding right-of-use assets resulting from the transition adjustment.

For an entity within the scope of (b), at the date of adoption of the pending content that links to this paragraph, the entity may choose to apply or discontinue using the risk-free rate for any class of underlying asset.

> Transition Related to Accounting Standards Update No. 2023-01, *Leases (Topic 842): Common Control Arrangements*

**65-7** The following represents the transition and effective date information related to the practical expedient in Accounting Standards Update No. 2023-01, *Leases (Topic 842): Common Control Arrangements*:

- a. The pending content that links to this paragraph shall be effective for fiscal years, including interim periods within those fiscal years, beginning after December 15, 2023. Early adoption is permitted in any annual or interim period for which financial statements have not yet been made available for issuance. If an entity adopts the pending content that links to this paragraph in an interim period, it shall adopt that pending content as of the beginning of the fiscal year that includes that interim period.
- b. An entity that adopts the pending content that links to this paragraph concurrently with adopting the pending content that links to paragraph 842-10-65-1 shall apply the pending content that links to this paragraph using the same transition method elected for the pending content that links to paragraph 842-10-65-1.
- c. An entity that adopted the pending content that links to paragraph 842-10-65-1 before adopting the pending content that links to this paragraph shall apply the pending content that links to this paragraph using either of the following two methods:
  1. Prospectively to arrangements that commence or are modified on or after the date that the entity first applies the pending content that links to this paragraph.
  2. Retrospectively to the beginning of the period in which the pending content that links to paragraph 842-10-65-1 was first applied. The pending content that links to this paragraph shall not be applicable for arrangements no longer in place at the date of adoption. Under this transition method:
    - i. If an arrangement previously considered to be a lease continues to be a lease after applying the pending content that links to this paragraph, an entity shall apply the requirements in paragraphs 842-10-25-9 through 25-17 to any changes in the lease resulting from application of the practical expedient in the pending content that links to this paragraph. Any amounts that otherwise would have been recognized in earnings shall be recognized as a cumulative-effect adjustment to opening retained earnings (or net assets of a not-for-profit entity) at the beginning of the earliest period presented in accordance with the pending content that links to paragraph 842-10-65-1.

- ii. If an arrangement previously not considered a lease becomes a lease after applying the pending content that links to this paragraph, an entity shall account for the arrangement as a new lease.
- d. An entity may document any existing unwritten terms and conditions of an arrangement between entities under common control before the date on which the entity's first interim (if applicable) or annual financial statements are available to be issued in accordance with the pending content that links to this paragraph.
- e. An entity within the scope of (c) shall provide the applicable transition disclosures required by Topic 250 on accounting changes and error corrections, except for the requirements in paragraphs 250-10-50-1(b)(2) and 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 earliest period presented but not before the date on which the pending content that links to paragraph 842-10-65-1 was adopted.
- f. An entity that elects the practical expedient(s) in paragraph 842-10-65-1(f) or (g) is not required to apply either of those practical expedients to common control arrangements for which the pending content that links to this paragraph is being applied.

**65-8** The following represents the transition and effective date information related to the accounting for leasehold improvements associated with leases between entities under common control in Accounting Standards Update No. 2023-01, *Leases (Topic 842): Common Control Arrangements*:

- a. The pending content that links to this paragraph shall be effective for fiscal years, including interim periods within those fiscal years, beginning after December 15, 2023. Early adoption is permitted in any annual or interim period for which financial statements have not yet been made available for issuance. If an entity adopts the pending content that links to this paragraph in an interim period, it shall adopt that pending content as of the beginning of the fiscal year that includes that interim period.
- b. An entity that adopts the pending content that links to this paragraph concurrently with adopting the pending content that links to paragraph 842-10-65-1 may apply the pending content that links to this paragraph using the same transition method elected for the pending content that links to paragraph 842-10-65-1 or may apply the pending content that links to this paragraph using either of the prospective methods specified in (c)(1) and (c)(2) below.
- c. An entity that adopted the pending content that links to paragraph 842-10-65-1 before adopting the pending content that links to this paragraph shall apply the pending content that links to this paragraph using one of the following methods:
  - 1. Prospectively to all new leasehold improvements recognized on or after the date that the entity first applies the pending content that links to this paragraph.
  - 2. Prospectively to all new and existing leasehold improvements recognized on or after the date that the entity first applies the pending content that links to this paragraph. An entity that elects this transition approach shall amortize the remaining balance of leasehold improvements existing at the date of adoption of the pending content

- that links to this paragraph over the remaining useful life of those improvements to the common control group determined at that date.
3. Retrospectively to the beginning of the period in which the pending content that links to paragraph 842-10-65-1 was first applied. Any leasehold improvements previously amortized or impaired that otherwise would not have been amortized or impaired had the pending content that links to this paragraph been applicable shall be recognized through a cumulative-effect adjustment to the opening balance of retained earnings (or net assets of a not-for-profit entity) at the beginning of the earliest period presented in accordance with the pending content that links to paragraph 842-10-65-1.
  - d. An entity within the scope of (c) shall provide the applicable transition disclosures required by Topic 250 on accounting changes and error corrections, except for the requirements in paragraphs 250-10-50-1(b)(2) and 250-10-50-3. An entity that elects the transition method in (c)(3) shall provide the transition disclosures in paragraph 250-10-50-1(b)(3) as of the beginning of the earliest period presented but not before the date on which the pending content that links to paragraph 842-10-65-1 was adopted.

> SEC Staff Guidance

- > SEC Staff Announcement: Transition Related to Accounting Standards Updates No. 2014-09 and 2016-02

**S65-1 Note:** At the December 2019 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff announced that it would not object to a public business entity that otherwise would not meet the definition of a public business entity except for a requirement to include or the inclusion of its financial statements or financial information in another entity's filing with the SEC adopting Topic 842, Leases, for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021. Those dates are consistent with the effective dates for Topic 842 as amended in Accounting Standards Update No. 2019-10, *Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates*. The following is the text of SEC Staff Announcement: Transition Related to Accounting Standards Updates No. 2014-09 and 2016-02.

FASB Accounting Standards Updates No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, issued in May 2014 and codified in ASC Topic 606, Revenue from Contracts with Customers, and No. 2016-02, *Leases (Topic 842)*, issued in February 2016 and codified in ASC Topic 842, Leases, provide effective dates that differ for (1) **public business entities** and certain other specified entities and (2) all other entities. The SEC staff has received inquiries from stakeholders regarding the application of the effective dates of ASC Topic 606 and ASC Topic 842 for a public business entity<sup>FN1</sup> that otherwise would not meet the definition of a public business entity except for a requirement to include or the inclusion of its financial statements or financial information in another entity's filing with the SEC.

The transition provisions in ASC Topic 606 require that a public business entity and certain other specified entities adopt ASC Topic 606 for annual

reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period.<sup>FN2</sup> All other entities are required to adopt ASC Topic 606 for annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019.

The transition provisions in ASC Topic 842 require that a public business entity and certain other specified entities adopt ASC Topic 842 for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years.<sup>FN3</sup> All other entities are required to adopt ASC Topic 842 for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020.

In response to the stakeholder inquiries outlined above, the SEC staff would not object to a public business entity that otherwise would not meet the definition of a public business entity except for a requirement to include or the inclusion of its financial statements or financial information in another entity's filing with the SEC adopting (1) ASC Topic 606 for annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019, and (2) ASC Topic 842 for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020.

A public business entity that otherwise would not meet the definition of a public business entity except for a requirement to include or the inclusion of its financial statements or financial information in another entity's filing with the SEC may still elect to adopt ASC Topic 606 and ASC Topic 842 according to the public business entity effective dates outlined above.

This announcement is applicable only to public business entities that otherwise would not meet the definition of a public business entity except for a requirement to include or the inclusion of its financial statements or financial information in another entity's filing with the SEC. This announcement is not applicable to other public business entities.

**FN 1** The definition of Public Business Entity in the FASB's ASC Master Glossary states, in part, the following:

A public business entity is a business entity meeting any one of the criteria below . . .

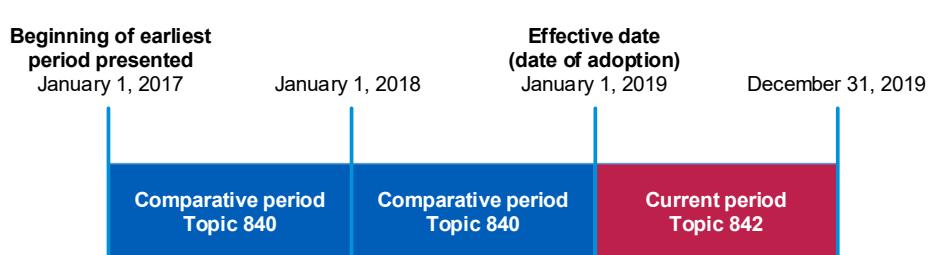
- a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing) . . .

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.

FN 2 Early adoption of ASC Topic 606 is permitted for public business entities and certain other specified entities only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.

FN 3 Early adoption of ASC Topic 842 is permitted for public business entities and certain other specified entities, as well as for all other entities.

13A.1.10 If a calendar year-end public business entity adopts Topic 842 in accordance with the mandatory effective date under the effective date method, it records a cumulative-effect adjustment on January 1, 2019. In the entity's December 31, 2019 financial statements, comparative reporting periods are presented in accordance with Topic 840, while the current period (2019) is presented in accordance with Topic 842 and its transition provisions.  
[\[842-10-65-1\(a\) – 65-1\(d\)\]](#)



13A.1.20 The effective date method is available as a transition option for adoption at any time after issuance of ASU 2018-11 – i.e. July 30, 2018. It can be applied as of the beginning of any period for which financial statements have not been issued or made available for issuance. [\[842-10-65-1\(a\) – 65-1\(b\)\]](#)

## Question 13A.1.10

### Early adoption considerations

#### What reasons might an entity have to early adopt Topic 842?

##### Interpretive response:

##### Lessors may want to align implementation with Topic 606

Most of the changes applicable to lessors transitioning from Topic 840 to Topic 842 were designed to substantially align key aspects of the lessor accounting model with the new revenue recognition guidance in Topic 606. For example, the guidance covering separation and allocation guidance for lease and non-lease components, the lease modifications guidance, and the contract combinations guidance are aligned with Topic 606, and the guidance on initial direct costs is aligned with Subtopic 340-40 (other assets and deferred costs related to contracts with customers). [\[ASU 2016-02.BC8\(d\)\]](#)

Those aspects of Topic 606 (and Subtopic 340-40) and Topic 842 that are substantially aligned are designed to work together. The Board's decision to align these aspects of the guidance explicitly considered that many lessors have contracts that contain lease and non-lease (e.g. services or supplies) components and that those lessors in particular would benefit from the alignment. Consequently, many lessors may find it preferable to early adopt Topic 842 at the same time as they adopt Topic 606.

#### **Entities may want to minimize disruption**

Most entities will likely be affected by the implementation of both Topic 606 and Topic 842. Some entities might view it as advantageous to adopt both Topics concurrently, in a big bang approach, to minimize the extent of ongoing systems and process changes, get past the disruption, and revert to a steady state accounting environment more quickly.

#### **Seller-lessees in real estate sale-leaseback transactions may want to early adopt**

As discussed in section 9.1, it will generally be easier to achieve sale accounting for real estate sale-leaseback transactions under Topic 842 than under Topic 840. A seller-lessee that has, or is contemplating, a significant real estate sale-leaseback transaction that is, or is expected to be, a failed sale under Topic 840 might want to early adopt Topic 842 if the transaction would be accounted for as a sale and a leaseback. For further discussion, see section 13A.7.

#### **Lessees with existing build-to-suit lease arrangements may want to early adopt**

Because of the existing build-to-suit lease accounting guidance in Topic 840, there are many lessees that have assets and liabilities recognized for assets that they do not legally own but were deemed to own for accounting purposes during the construction period. In some of those cases, the construction period ended many years ago but, because of the restrictive sale-leaseback requirements applicable to real estate under Topic 840, the entity has been unable to derecognize those assets and liabilities. Because the transition provisions in Topic 842 applicable to build-to-suit leases and sale-leaseback transactions may permit the entity to derecognize those assets and liabilities (see section 13A.8), some entities in this situation may choose to early adopt Topic 842.



#### Question 13A.1.30

#### **Issuance of a registration statement on Form S-3 after the effective date**

#### **Does the reissuance of a registrant's financial statements in conjunction with filing a registration statement on Form S-3 change the date of initial application?**

**Background:** A calendar year-end public entity adopts Topic 842 on January 1, 2019 using the effective date method and does not restate its 2018 and 2017

comparative periods. In May 2019, the registrant files its first quarter 2019 Form 10-Q, which reflects the adoption of Topic 842. Shortly after, the registrant files a registration statement on Form S-3 that includes financial statements for the years ending December 31, 2018, 2017 and 2016, as well as the quarters ending March 31, 2019 and 2018.

Item 11(b)(ii) of Form S-3 requires retrospective revision of the pre-event audited financial statements that were incorporated by reference in the Form S-3 to reflect a subsequent change in accounting principle.

**Interpretive response:** No. The reissuance of the financial statements in the Form S-3 does not change the date of initial application from January 1, 2019 in the background example. [FRM 11210.1]



### Question 13A.1.50 Effective date for certain public business entities

**Does an entity that is considered a 'public business entity' solely because its financial statements or summarized financial information are included in an SEC filing have to follow the mandatory effective date for public business entities?**

**Interpretive response:** No. At the July 20, 2017 EITF meeting, the SEC Observer announced that the SEC staff will not object if certain public business entities (PBEs) use the adoption dates for 'other entities'. The SEC announcement was later codified in paragraph 842-10-S65-1. [842-10-S65-1]

The SEC staff has confirmed its intent to continue to extend relief to those same PBEs based on the principles in paragraph 842-10-S65-1. This means that although paragraph 842-10-S65-1 references the 'other entities' mandatory effective date enacted by ASU 2019-10, PBEs eligible for the SEC staff relief can avail themselves of the additional one-year extension of that date afforded by ASU 2020-05. See 'How the standard works' in this chapter for effective date information. [CAQ SEC Regs Comm 07/2020, 842-10-S65-1]

The SEC staff's effective date relief is narrow and applies to an entity that otherwise would not meet the definition of a PBE, but does so *only* because its financial statements or summarized financial information is included in another entity's SEC filing.

Situations where the SEC staff's relief may apply include, but are not limited to:

- private company equity method investees;
- private acquired businesses;
- acquired real estate operations;
- properties securing loans that represent an asset concentration;
- significant lessees; and
- affiliates whose securities constitute a substantial portion of the collateral of a security that is registered or being registered with the SEC.

A private entity whose financial information is included in an SEC filing but also meets the definition of a PBE for other reasons – e.g. the filing of financial statements with a regulatory agency other than the SEC – is not eligible for the SEC's relief.



### Question 13A.1.60

#### **Effective date for an entity in the process of an initial public offering (IPO)**

### **What is a non-EGC's Topic 842 adoption date when issuing financial statements to be included in an IPO registration statement?**

**Interpretive response:** An entity that is not an EGC uses the adoption date that would have applied to it had it been a public business entity (PBE) all along (e.g. January 1, 2019 if it is a calendar year-end company). This is regardless of whether the entity has already or has not yet adopted Topic 842. [\[CAQ SEC Regs Comm 07/2020.III.A\]](#)

For example, even if calendar year-end non-EGC Entity A has already adopted Topic 842 as of January 1, 2021, its IPO registration statement financial statements are adjusted to reflect adopting Topic 842 as of January 1, 2019. The entity presents the effects of Topic 842 in all periods presented from that date.

By contrast, during and after the IPO registration process, an EGC is permitted to use the Topic 842 adoption dates for non-PBEs (i.e. January 1, 2022 for annual periods and January 1, 2023 for interim periods). Question 13A.2.140 addresses adoption guidance for an entity when it loses its EGC status.

## 13A.2 Transition principles – lessees and lessors



### **Excerpt from ASC 842-10**

#### **65 Transition and Open Effective Date Information**

##### **General**

> Transition Related to Accounting Standards Updates No. 2016-02, *Leases (Topic 842)*, No. 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*, No. 2018-10, *Codification Improvements to Topic 842, Leases*, No. 2018-11, *Leases (Topic 842): Targeted Improvements*, No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, 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*, No. 2020-05, *Revenue from Contracts with Customers (Topic 606)* and *Leases (Topic 842): Effective Dates for Certain Entities*, No. 2021-05, *Leases (Topic 842)*:

*Lessors—Certain Leases with Variable Lease Payments, No. 2021-09, Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities, and No. 2023-01, Leases (Topic 842): Common Control Arrangements*

**65-1** The following represents the transition and effective date information related to Accounting Standards Updates No. 2016-02, *Leases (Topic 842)*, No. 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*, No. 2018-10, *Codification Improvements to Topic 842, Leases*, No. 2018-11, *Leases (Topic 842): Targeted Improvements*, No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, 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*, No. 2020-05, *Revenue from Contracts with Customers (Topic 606)* and *Leases (Topic 842): Effective Dates for Certain Entities*, No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*, No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*, and No. 2023-01, *Leases (Topic 842): Common Control Arrangements*: [Note: See paragraph 842-10-S65-1 for an SEC Staff Announcement on transition related to Update 2016-02.]

- 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).

### Practical expedients

- 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.
- g. An entity also may elect a practical expedient, which must be applied consistently by an entity to all of its leases (including those for which the entity is a lessee or a lessor) to use hindsight in determining the **lease term** (that is, when considering lessee options to extend or terminate the lease and to purchase the **underlying asset**) and in assessing impairment of the entity's **right-of-use assets**. This practical expedient may be elected separately or in conjunction with either one or both of the practical expedients in (f) and (gg).
  - 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.

### 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-S99-6 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.

### 13A.2.1 Transition approach – general

13A.2.10 When an entity elects the effective date method, it recognizes and measures all leases that exist at the effective date using a modified retrospective transition approach. The entity records a cumulative-effect adjustment as of the effective date. Comparative periods are presented in accordance with Topic 840 and do not include any retrospective adjustments to comparative periods to reflect the adoption of Topic 842. All leases that either (1) commence, or (2) are modified (where that modification is not accounted for as a separate contract) or remeasured on or after the effective date are accounted for under Topic 842. [842-10-65-1(c) – 65-1(d), 65-1(q), 65-1(t)]

13A.2.20 As an exception, a lessee electing the recognition and measurement exemption for short-term leases (see section 6.3.1) does not apply the transition requirements to short-term leases. For purposes of this exception, a short-term lease is a lease with a *total* lease term of 12 months or less (including periods before the effective date); it is not a lease with a *remaining* lease term of 12 months or less at the effective date. See Question 13A.2.60 for considerations about whether a lease is a short-term lease in transition if electing to use hindsight. [842-10-65-1(e)]

13A.2.30 Topic 842 does not specify what to do instead for unrecognized short-term leases in transition. However, we believe the lessee should:

- recognize the minimum rental payments (as defined in Topic 840 – see Question 13A.3.10) as lease cost, on a generally straight-line basis over the lease term, consistent with the lessee's accounting for those leases under Topic 840; and
- consistent with all other lessee leases that exist at the effective date, apply the new requirements in Topic 842 to that lease if, on or after the effective date:
  - it is modified and that modification is not accounted for as a separate contract (see section 6.7); or
  - there is an event that would require remeasurement of the lease liability if it were recognized – e.g. a change in the lease term or in the assessment of a lessee purchase option (see section 6.6).

13A.2.40 An entity adjusts equity at the effective date as if Topic 842 had always been applied, subject to the transition requirements described in this chapter. [842-10-65-1(d)]

13A.2.50 An entity applies the transition requirements to leases that commence before the effective date (or early adoption date) at that date. [842-10-65-1(k), 65-1(r), 65-1(s), 65-1(v), 65-1(w), 65-1(x), 65-1(y)]



### Observation

#### **Additional transition method offers relief to preparers**

13A.2.60 The effective date method provides significant relief to preparers that were encountering unanticipated costs and complexities implementing Topic 842 using the comparative method. Election of the effective date method will simplify transition for many of these entities. [ASU 2018-11.BC7]

13A.2.70 A primary concern with allowing this optional transition method that does not restate comparative financial statements is the potential information loss to financial statement users. By removing the requirement to apply Topic 842 to comparative periods in transition, a lessee does not recognize operating lease assets and liabilities on the balance sheet for any comparative period. However, the Board noted in the basis for conclusions to ASU 2018-11 that the disclosures required under Topic 840 for the comparative periods, which are required under this transition method to be provided in the entity's adoption-year financial statements, would still provide users with relevant information about the comparative periods. Ultimately, the election of this transition method will only delay the availability of comparative financial statement information on operating lease assets and liabilities by one year, somewhat mitigating concerns about comparability of information in the financial statements. [ASU 2018-11.BC8-BC11]

13A.2.80 Electing this new transition method only impacts *when*, but not *how*, an entity adopts Topic 842. This means that the recognition and measurement principles are the same under both the effective date and comparative methods, but the timing of initial ROU asset and lease liability recognition for existing operating leases, and first preparation of Topic 842 disclosures for all leases (see Chapter 12), will be different. [ASU 2018-11.BC10]

## **13A.2.2 Transition approach – modifications**

13A.2.90 There is no 'transition period' when an entity elects the effective date method. Therefore, there are no separate considerations for lease modifications that occur during a transition period. Any modifications that occur before the effective date of Topic 842 are subject to the guidance in Topic 840. These leases are transitioned in the same manner as other leases that have commenced before the effective date, which means the transition adjustment for those leases considers the terms and conditions of the lease in effect as of that date – i.e. subsequent to any modifications before that date. Modifications that occur after the effective date are subject to the guidance in Topic 842.

13A.2.100 Lessees will not reassess or remeasure leases before the effective date. Beginning on the effective date, the same reassessment and remeasurement requirements apply to leases that commenced before the

effective date as apply to new leases that commence on or after the effective date – i.e. Topic 842 applies in: [842-10-65-1(q), 65-1(t)]

- determining when to reassess a lease and whether there is a resulting remeasurement (see section 6.6.1);
- accounting for the remeasurement (see section 6.6.2); and
- accounting for the lease after the remeasurement (see section 6.6.2).

### 13A.2.3 Practical expedients

13A.2.110 The following table summarizes the three transition practical expedients in Topic 842. An entity electing the land easement practical expedient only applies the transition guidance in Topic 842, including the following practical expedients, to land easements that were *accounted for* as leases under Topic 840. [842-10-65-1(f) – 65-1(gg)]

Package of practical expedients	Use of hindsight	Land easements
<p>On transition, an entity may elect <i>not</i> to reassess:</p> <ul style="list-style-type: none"> <li>— whether expired or existing contracts contain a lease under the new definition of a lease (see chapter 3);</li> <li>— lease classification for expired or existing leases – see sections 6.2 (lessees) and 7.2 (lessors); and</li> <li>— whether previously capitalized initial direct costs would qualify for capitalization under Topic 842 (see section 5.5).</li> </ul> <p>An entity electing this practical expedient must elect the entire package.</p>	<p>An entity may use hindsight in determining the lease term, assessing the likelihood that a lessee renewal, termination or purchase option will be exercised (see section 5.3).</p>	<p>An entity may elect not to reassess whether land easements meet the definition of a lease if they were not accounted for as leases under Topic 840. Section 13A.2.4 discusses this practical expedient in further detail.</p>
Each of the three practical expedients may be elected separately from the other two.		
Practical expedients are applied consistently to all leases – i.e. all leases for which the entity is a lessee or a lessor – that commence before the effective date.		

13A.2.120 An entity that elects to apply the package of practical expedients will, in effect, continue to account for existing leases (i.e. leases for which the commencement date is before the effective date) in accordance with Topic 840 throughout the entire lease term, including periods after the effective date. The following are exceptions to this general principle. [ASU 2016-02.BC390]

Lessees only	Lessees and lessors
<p>Recognize an ROU asset and a lease liability for all operating leases at each reporting date after the effective date (see section 13A.3).</p> <p>Apply the Topic 842 reassessment requirements (see section 6.6) beginning on the effective date and, if the lease liability is remeasured on or after the effective date, account for the lease under Topic 842 beginning on the remeasurement date (see paragraph 13A.2.90).</p>	<p>If the lease is modified and not accounted for as a separate contract (see sections 6.7 and 7.6 for lessees and lessors, respectively) on or after the effective date, account for the lease under Topic 842 beginning on the effective date of the modification (see paragraph 13A.2.90).</p>

13A.2.130 An entity that elects the land easements practical expedient continues to account for existing land easements (i.e. land easements that commenced before the effective date) consistent with its historical accounting practice before adopting Topic 842. An exception to this general principle arises if a land easement is modified on or after the effective date. [842-10-65-1(gg), ASU 2018-01.BC17]



### Question 13A.2.20 Date of lease classification reassessment

**If an entity does not elect the package of practical expedients, and is therefore required to reassess the classification of its existing leases, as of what date does that reassessment occur?**

**Interpretive response:** An entity reassesses lease classification for each lease that commences before the effective date of Topic 842 as of the later of:

- the commencement date for the lease; or
- the date of the last lease modification that, in accordance with Topic 840, required the entity to reassess the classification of the lease.



### Question 13A.2.30

#### **Hindsight practical expedient – effect on lease classification if package of practical expeditents elected**

**If an entity elects both the package of practical expeditents and the use of hindsight, is it required to reassess lease classification if hindsight results in a change to the lease term or the assessment of a lessee purchase option?**

**Interpretive response:** No. Topic 842 does not establish a hierarchy between these two transition practical expeditents such that hindsight overrides the package of practical expeditents. Therefore, even though changes to the lease term or the assessment of a lessee purchase option resulting from the use of hindsight require, for example, the lessee to remeasure the minimum rental payments (existing operating leases) or the minimum lease payments (existing capital leases – see Question 13A.2.50), we do not believe an entity (lessee or lessor) is required to reassess lease classification if it has elected the package of practical expeditents.

However, we also do not believe that Topic 842 *precludes* reassessing lease classification in such cases. This is on the basis that the hindsight practical expedient was intended to permit entities to provide more accurate, updated information to financial statement users unhindered by their decisions with respect to other transition practical expeditents – e.g. the package of practical expeditents. [\[ASU 2016-02.BC394\]](#)



### Question 13A.2.40

#### **Hindsight practical expedient – lessee options**

**Does the hindsight practical expedient require an entity to reassess the lease term and any lessee purchase options? If yes, at what date does that reassessment occur and what factors does it consider?**

**Interpretive response:** Yes, election of the hindsight practical expedient requires an entity (lessee or lessor) to reevaluate the lease term and the entity's assessment of any lessee purchase options on the effective date of Topic 842.

The reassessment takes into account all economic factors relevant to that assessment as of the effective date: contract-based, asset-based, market-based and entity-based factors (see paragraph 5.2.60). That is, an entity assesses as of the effective date, with the benefit of hindsight, the same factors it considers at lease commencement for new leases that commence on or after the effective date. The entity then uses that updated information to establish the measurement of the lease at the effective date – i.e. rather than the entity's 'reasonably assured' assessment that it undertook under Topic 840.

This requirement, resulting from election of the hindsight practical expedient, is regardless of:

- the fact that lessors do not reassess such items for leases that commence *on or after* the effective date of Topic 842 (unless the lease is modified and that modification is not accounted for as a separate contract); and
- whether or not any ‘triggering events’ (i.e. significant events or changes in circumstances within the control of the lessee) have occurred before the effective date.

The following are examples (which would apply equally to the lessee or the lessor).

— **Example 1: Changes in market value**

A lessee concluded at lease inception under Topic 840 that exercise of a renewal option was not reasonably assured and the lease term excluded the optional renewal period.

On the effective date of Topic 842, it is clear that the renewal option will be a significant bargain from fair market rent for the underlying asset at the time of renewal such that it is reasonably certain (based on market factors) that the lessee will exercise the renewal option.

Therefore, when applying hindsight, the remaining lease term used to measure the lease at the effective date will include the optional renewal period.

— **Example 2: Impact of leasehold improvements**

A lessor concluded at lease inception under Topic 840 that exercise of a renewal option by the lessee was not reasonably assured and excluded the optional renewal period from the lease term.

By the effective date of Topic 842, the lessee has constructed significant leasehold improvements that will have significant remaining economic value to the lessee after the optional renewal date such that the lessee is reasonably certain to exercise the renewal option.

Therefore, when applying hindsight, the remaining lease term used to measure the lease at the effective date will include the optional renewal period.

Subsequent to the effective date – i.e. after the entity undertakes the hindsight reassessment – leases that commenced before the effective date are reassessed on the same basis as new leases that commenced on or after the effective date. That is, lessors do not reassess the lease term or lessee purchase options unless the lease is modified (and that modification is not accounted for as a separate contract) – see section 7.6, and lessees reassess the lease term only as discussed in section 6.6 on reassessments and section 6.7 on modifications.

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### Question 13A.2.50

#### Hindsight practical expedient – existing capital (sales-type/direct financing) leases

**If hindsight results in a change to the lease term or the assessment of a lessee purchase option, does an entity remeasure an existing capital (sales-type/direct financing) lease if its classification does not change on transition?**

**Background:** Topic 842 states that:

- The lease liability and ROU asset for an existing capital lease that remains classified as a finance lease under Topic 842 are initially measured at the effective date as follows (see paragraph 13A.3.100). [842-10-65-1(r)(1) – 65-1(r)(2)]
  - **Lease liability:** Carrying amount of capital lease obligation under Topic 840 immediately before the effective date.
  - **ROU asset:** Carrying amount of the capital lease asset under Topic 840 immediately before the effective date, plus any unamortized initial direct costs not included in the capital lease asset.
- The net investment in the lease at the effective date for a sales-type or direct financing lease that remains classified as a sales-type or direct financing lease under Topic 842 is measured at the carrying amount of the net investment immediately preceding the effective date under Topic 840 (see paragraph 13A.4.40). [842-10-65-1(x)(1)]

**Interpretive response:** Yes. If hindsight results in a change to the lease term or the assessment of a lessee purchase option, the lease assets and lease liabilities should be remeasured. This is notwithstanding the Topic 842 transition paragraphs referenced in the background.

Election of the hindsight practical expedient is optional; therefore, the decision to apply this practical expedient includes acceptance of the remeasurement requirements that accompany that decision. The hindsight practical expedient, if elected, is intended to provide more accurate, updated information to financial statement users. It is unclear how that would be accomplished if the use of hindsight results in a changed lease term or changed assessment of a lessee purchase option but the entity does not reflect that change in its measurement of lease assets and lease liabilities. [ASU 2016-02.BC394]



## Question 13A.2.60

### Hindsight practical expedient – short-term leases

**Does the exercise of one or more renewal options that result in a cumulative lease term greater than 12 months preclude accounting for the lease as a short-term lease when applying the hindsight practical expedient on transition?**

**Background:** Consider an example whereby Lessee LE enters into a lease that commences on January 1, 2017 that has a non-cancellable period of 12 months and three 12-month lessee renewal options. At January 1, 2017, it is not reasonably certain that LE will exercise any of the renewal options; therefore, the lease term is 12 months.

As of the effective date (January 1, 2019 for LE), LE has exercised two of the renewal options – i.e. as of the effective date, the current non-cancellable period of the lease extends to December 31, 2019. At no point in time before exercise was it ever ‘reasonably certain’ that LE would exercise one or more of those options (see section 5.2), and it is not reasonably certain at the effective date that LE will exercise its one remaining option to extend the lease to December 31, 2020.

LE has elected the hindsight transition practical expedient and is now considering whether this lease qualifies for the short-term lease recognition and measurement exemption given LE knows that the lease will have a total term, in hindsight, of at least three years.

**Interpretive response:** It depends. If the initial lease term was 12 months or less and no single renewal option exercised by the lessee up to the effective date extended the lease term by more than 12 months from the end of the previously determined lease term, the lease qualifies as a short-term lease on transition; this is even if the lessee elected the hindsight practical expedient.

Therefore, in the background example, the lease qualifies as a short-term lease, despite LE’s use of the hindsight practical expedient. This is because the original lease term was 12 months or less and neither of the two renewal options exercised by LE extended the lease term by more than 12 months from the end of the then-current lease term at the point in time the option was exercised.

However, a lease such as that in the background example would not qualify, if using hindsight, as a short-term lease at the effective date if any *single* renewal option was exercised that extended the lease term by *more than* 12 months from the end of the previously determined lease term or if LE had exercised more than one of the available 12-month renewal options during the same then-current 12-month lease term. For example, if the background lease had an initial term of 12 months, but LE exercised a single 24-month renewal option, rather than two 12-month renewal options, or had exercised both of the two 12-month renewal options during the initial 12-month term of the lease, it would not be considered a short-term lease.

While not explicit in the guidance, we believe this interpretation of the Topic 842 transition guidance is consistent with the post-transition guidance that says a lease does not lose its short-term categorization unless the lease term changes such that, after the change, the remaining lease term extends more than 12 months from the end of the previously determined lease term.

[842-20-25-3]



### Question 13A.2.70

#### **Hindsight practical expedient – changes to straight-line operating lease income (expense)**

#### **If the lease term changes as a result of applying the use-of-hindsight practical expedient, does the entity need to revise its straight-line income (expense) recognition?**

**Background:** Lessor LR and Lessee LE are public business entities that entered into a five-year lease that commenced on January 1, 2014. The lease included a five-year lessee renewal option, which LR and LE both excluded from the lease term in their historical accounting.

Both LR and LE classified the lease as an operating lease under Topic 840, and concluded that income (expense) should be recognized on a straight-line basis. The annual payments for the lease increase by 5 percent each year, including during the optional renewal period.

By the effective date of Topic 842 (January 1, 2019) LE has exercised the renewal option to extend the term of the lease. Both LR and LE elect the use-of-hindsight practical expedient.

**Interpretive response:** Yes. If the lease term changes as a result of hindsight, the entity is required to adjust all of its related accounting correspondingly.

If the effect of applying hindsight means that the income (expense) recognized in prior periods would have been different from what was historically reported, the entity recognizes any necessary adjustment to equity on the effective date.

Using the background example, because of the annual 5% payment escalator, LR and LE would have recognized additional lease income (expense) in January 1, 2014 to December 31, 2018 had they both estimated a lease term of 10 years rather than 5 years. The use of hindsight by LR and LE means they will recognize less lease income (expense) after the effective date than they would have had they not elected the use-of-hindsight practical expedient.



### Question 13A.2.80

#### Hindsight practical expedient – remeasurement events

**When applying hindsight, does a remeasurement arising from an event that occurs, or change in circumstances that arises, on or after the effective date affect measurement of the lease at the effective date?**

**Interpretive response:** No. As outlined in Question 13A.2.40, election of the hindsight practical expedient *requires* an entity (lessee or lessor) to reevaluate the lease term and the entity's assessment of any lessee purchase options as of the effective date. At that date, an entity considers all economic factors relevant to that assessment for each of its leases: contract-based, asset-based, market-based and entity-based factors (see paragraph 5.2.60).

After that effective date reassessment occurs, any changes to the lease term or to the assessment of lessee purchase options that result from applying the guidance in Topic 842 (e.g. resulting from a 'triggering event' for lessees or from the reassessment of the lease upon a modification that is not accounted for as a separate contract for lessees and lessors) are post-transition accounting events – i.e. they are not 'pushed back' into the cumulative-effect adjustment at the effective date.



### Question 13A.2.90

#### Hindsight practical expedient – changes to an index or rate on which variable lease payments are based

**Does using hindsight contemplate changes to a reference index or rate on which variable lease payments are based at the effective date?**

**Interpretive response:** No. We believe using hindsight is intended to apply to estimates and other matters of judgment, such as assessments the entity made at lease inception under Topic 840 about the likelihood that the lessee will exercise an option to renew (or terminate) the lease or exercise an option to purchase the underlying asset.

We do not believe the Board intended for entities to use the hindsight practical expedient to reflect changes in fact, such as actual changes in a reference index or rate upon which some or all of the variable lease payments in a lease depend. Therefore, when measuring the lease liability for a lease at the effective date, an entity should use the index or rate as indicated in Question 13A.3.30.



### Example 13A.2.10

#### Applying hindsight with lease remeasurements and modifications

This example illustrates the interpretive guidance provided in Questions 13A.2.30 – 13A.2.90 about applying the hindsight practical expedient in evaluating lease remeasurements and modifications.

The following table summarizes relevant information about Lessee LE's lease of a warehouse facility from Lessor LR. LE and LR have both elected to use the package of transition practical expedients and the hindsight practical expedient.

Commencement date of lease:	January 1, 2004
Lease term:	15 years
Terms of renewal options:	<p>One 10-year option. LE must notify LR six months before the end of the term that LE will not exercise the option or the option is deemed exercised.</p> <p>At lease inception, exercise of the renewal option by LE is not reasonably assured.</p>
Effective date for LE:	January 1, 2019

#### Scenario 1: Lessee option exercised during comparative period

LE did not notify LR of its intent to terminate the lease on or before July 1, 2018. As a result, because July 1, 2018 represents six months before the end of the original lease term, the renewal option has been exercised in accordance with the terms of the contract.

In this scenario, the remaining lease term is 10 years for both LE and LR as of January 1, 2019 (transition date for the lease under the effective date method).

#### Scenario 2: Lessee option exercised after the effective date

Assume the same facts as in Scenario 1, except the commencement date of the lease was January 1, 2005 and therefore the non-cancellable period of the lease ends December 31, 2019. This means that the date by which LE must notify LR of its intent not to exercise the extension option is July 1, 2019 (rather than July 1, 2018).

In this scenario, if the entity (LE or LR) concludes, based on consideration of all relevant economic factors as of the effective date (see Question 13A.2.40), that LE is reasonably certain to extend the lease beyond December 31, 2019, the remaining lease term will be 11 years (January 1, 2019 – December 31, 2029) at the effective date.

If LE is not reasonably certain to exercise the option to extend the lease as of the effective date, the remaining lease term is only one year (January 1, 2019 – December 31, 2019) at the effective date. If LE exercises the option on July 1, 2019, that extension of the lease term does not affect the conclusion reached on transition that the remaining lease term is one year at the effective date. The exercise of the option is solely a 'post-transition' accounting event for both LE and LR.

### Scenario 3: Lease modification after the effective date

Assume the same facts as Scenario 2, except that the lease does not include a renewal option for LE. However, LE and LR agree on February 1, 2019 to modify the lease to extend its term for 10 years following the end of the non-cancellable period of the lease (which is December 31, 2019).

Despite the fact that the modification occurred only one month after the effective date and before LE or LR have issued financial statements under Topic 842, the lease term extension resulting from the modification is not reflected in the remaining lease term at the transition date (i.e. the effective date of January 1, 2019). Therefore, the remaining lease term at January 1, 2019 is one year: January 1, 2019 – December 31, 2019. The change in the lease term resulting from the modification is not reflected in the financial statements until the effective date of the modification.



### Question 13A.2.100 Errors in applying Topic 840

#### Does election of the package of practical expedients require entities to correct errors in applying Topic 840 with respect to lease identification, lease classification and the accounting for initial direct costs?

**Interpretive response:** Yes. Election of the package of practical expedients does not grandfather errors in applying Topic 840; it only grandfathered the Topic 840 guidance.

Therefore, if the package of practical expedients is elected, incorrect conclusions reached under Topic 840 about the following must be corrected, separate from the transition accounting for those leases, *in accordance with the guidance in Topic 840*:

- whether a contract is or contains a lease (including incorrect conclusions about whether a contract or part of a contract was in the scope of Topic 840);
- lease classification; and/or
- the accounting for initial direct costs.

The effect of correcting an error in applying Topic 840 is excluded from the transition effect of applying Topic 842. An entity corrects any error under Topic 840 before applying the transition guidance in Topic 842. For example, if an entity wrongly concluded that a contract did not contain a lease under Topic 840, the entity would recognize that lease in transition even if that contract would not contain a lease under Topic 842. For the specific requirements related to land easements, see Section 13A.2.4. [\[ASU 2016-02.BC393\(a\)\]](#)

Identifying a lease may be the most likely area of error to which the package of practical expedients applies. Many contracts convey the right to use property, plant or equipment, but are not explicitly identified as 'lease agreements'.

Examples include service contracts (including contracts for IT services), dedicated supply agreements, advertising and construction contracts. Under Topic 840, an entity may not have had a significantly different expense recognition pattern or balance sheet treatment regardless of whether a transaction was accounted for as an operating lease or as an executory or service contract. Accordingly, entities may not have previously focused their efforts on identifying contracts that explicitly or implicitly contained operating leases.

However, under Topic 842 identifying leases becomes much more important because entities recognize lease liabilities and ROU assets on the balance sheet for each lease with a term that is longer than 12 months. Accordingly, the Board decided that the package of practical expedients should not provide an exemption for arrangements that were not accounted for as leases under Topic 840 even though they met the Topic 840 definition.



### Question 13A.2.110

#### **Grandfathering arrangements committed or agreed to before reporting periods beginning after May 28, 2003**

#### **Are arrangements that were grandfathered from application of the lease identification guidance in Topic 840 still grandfathered on transition to Topic 842?**

**Background:** Under Topic 840, arrangements not accounted for as leases that were committed or agreed to before reporting periods beginning after May 28, 2003 (and not subsequently modified or acquired in a business combination) were grandfathered from determining whether the arrangement is or contains a lease.

**Interpretive response:** Yes, but only if the entity elects the package of transition practical expedients. Topic 842 does not carry forward that grandfathering provision, so unless the package of practical expedients is elected, the entity must reassess whether leases exist for all arrangements that have not ended before the effective date.

However, the package of practical expedients grandfathers the Topic 840 lease identification guidance for all leases that commence before the effective date of Topic 842. We believe this includes the grandfathering provision in Topic 840. Therefore, if an entity elects the package of practical expedients, leases previously eligible for this grandfathering provision would remain eligible for that provision.

Because the grandfathering provision in Topic 840 does not apply to leases modified after May 28, 2003, entities will need to have a process in place to ensure that any modified contracts initially eligible for the grandfathering provision were reassessed under Topic 840 upon modification, as well as a process in place to monitor any such contracts for modifications that occur on or after the effective date of Topic 842. If a contract previously eligible for the Topic 840 grandfathering provision is modified on or after the effective date, the

entity will have to assess whether the contract is or contains a lease under Topic 842.



### Observation

#### **Impact on initial direct costs for entities not electing the package of practical expedients**

13A.2.140 An entity's decision not to elect the package of practical expedients for lease definition, lease classification and initial direct costs may not have a significant effect on the entity unless it has previously incurred a significant amount of initial direct costs. This is because the new definition of a lease and the new lease classification guidance will likely yield similar outcomes to the related guidance in Topic 840 in most cases (assuming no errors in applying Topic 840 – see Question 13A.2.100). However, because substantially fewer costs qualify as initial direct costs under Topic 842 (see section 5.5), the effect of electing (or not electing) the package of practical expedients may be significant for entities that incur significant lease origination costs.

[IASU 2016-02.BC393(c)]

## 13A.2.4 Land easements

13A.2.150 A land easement is, in general, a right to use and/or enter (or cross) land owned by another party for a specific purpose, for which the rights vary depending on the easement. Land easements may be perpetual or for a defined term, may be prepaid or paid over time, and may provide for exclusive or nonexclusive (shared) use of the land. For a discussion of land easements and the scope of Topic 842, see Question 2.3.10.

13A.2.160 As some entities did not assess whether land easements met the definition of a lease under Topic 840, stakeholders expressed concern to the Board that it would be costly and complex to evaluate those land easements in transition. As a result, the Board added an optional transition practical expedient specifically for land easements. It allows an entity to elect not to assess whether any expired or existing land easements are, or contain, leases at transition if they were not previously *accounted for* as leases under Topic 840. An entity that elects this practical expedient should assess any new or modified land easements on or after the effective date under Topic 842.

13A.2.170 This practical expedient does not apply to any land easements that were previously accounted for as leases under Topic 840. Such land easements are subject to the same transition guidance as other identified leases.

13A.2.180 This practical expedient is available separately, or in conjunction with either or both of the other practical expedients: the all-or-nothing package of practical expedients, and the ability to use hindsight (see section 13A.2.3). An entity that does not elect the land easements practical expedient must either:

- If the package of practical expedients is not elected: reassess whether its land easements meet the Topic 842 definition of a lease; or

- If the package of practical expedients is elected: ensure that its Topic 840 conclusions about whether its land easements were, or contained, leases were correct (see Question 13A.2.100).



## Observation

### Prior land easement accounting is grandfathered

13A.2.190 The Board specifically provided this transition practical expedient for land easements that were not *accounted for as leases* under Topic 840, rather than land easements that were not *assessed* under Topic 840. In practical terms, this means that land easements that were accounted for under non-lease guidance do not need to be reassessed to determine if they met the definition of a lease either under Topic 840 (if the package of practical expedients is elected) or Topic 842 (if the package of practical expedients is not elected) before transition. As a result, election of the practical expedient will essentially grandfather the legacy accounting for any land easements that exist at (i.e. have commenced before) the effective date of Topic 842, including any erroneously determined not to be a lease under Topic 840.

13A.2.200 This differs from other transition guidance in Topic 842, which specifies that errors in the application of Topic 840 are not grandfathered (see Question 13A.2.100). If an entity does not elect this practical expedient, it cannot overlook land easements that were erroneously not accounted for as leases under Topic 840, even if the entity elects the package of practical expedients. [ASU 2016-02.BC393(a)]



## Question 13A.2.120

### Land easements arising before the effective date

## Can an entity change its accounting policy for land easements before the effective date of Topic 842?

**Interpretive response:** No. An entity that elects the optional transition practical expedient for land easements is required to continue to apply consistent accounting policies to new or modified contracts entered into before the effective date of Topic 842. Therefore, an entity that previously accounted for land easements under Topic 840 should continue to apply Topic 840 to new land easements arising before the effective date. For example, a new ground lease agreement (which could be characterized as a land easement) commencing before the effective date of Topic 842 is not eligible for the practical expedient because similar ground leases had previously been accounted for by the entity as leases under Topic 840. [ASU 2018-01.BC17]

Alternatively, if the entity has historically accounted for a population of land easements under other guidance (e.g. Topics 350 or 360), the entity should continue to apply that accounting policy to all similar land easements entered

into before the effective date of Topic 842. In this case, the entity is eligible to apply the practical expedient to those land easements in transition.

## 13A.2.5 Disclosures

13A.2.210 In addition to the ongoing disclosures required by Topic 842 for lessees and lessors, an entity generally provides the transition disclosures required for accounting changes and error corrections. As an exception, an entity is not required to disclose the effect of the change on income from continuing operations, net income and per-share amounts for the interim and annual periods post-adoption. [842-10-65-1(i), 250-10-50-1(b)(2), 250-10-50-3]

13A.2.220 If an entity elects the package of practical expedients, the practical expedient to use hindsight and/or the land easements practical expedient, it discloses that fact. [842-10-65-1(j)]

13A.2.230 Before the effective date, SEC registrants are required to evaluate new accounting standards that they have not yet adopted and to disclose their potential material effects. These disclosures generally should include a discussion about the effect that adoption is expected to have on the financial statements, unless this is not known or reasonably estimable. [SAB Topic 11.M]

13A.2.240 While Topic 842 requires only certain lessor disclosures to be made in all interim financial statements, Article 10 of Regulation S-X requires SEC registrants to provide both the applicable lessor and lessee annual and interim disclosures in each interim period included in the entity's quarterly reports on Form 10-Q in the year of adoption of a new accounting standard (see Question 12.1.20).

13A.2.250 Under the effective date method, an entity only presents disclosures for periods subsequent to the effective date in accordance with Topic 842. The entity does not present Topic 842 disclosures for periods before the effective date (see Question 13A.2.130). However, the entity must carry forward all of the disclosures that were required under Topic 840 for comparative periods before the effective date that are presented in the entity's post-adoption financial statements. This is different from the comparative method, which requires that the Topic 842 disclosures – i.e. in lieu of the disclosures originally provided for the applicable comparative period under Topic 840 – be prepared for all periods presented (see Question 13B.2.120). [842-10-65-1(jj)]

13A.2.260 The disclosures of future operating and capital lease commitments was only required under Topic 840 for the last annual balance sheet date presented in the lessee's financial statements (notwithstanding interim disclosure guidance under Topic 270 that could apply under some circumstances). However, the transition provisions applicable to the effective date method mandate that these lease commitments disclosures, as of the last balance sheet prepared under Topic 840, be carried forward and presented by the entity in each set of interim and annual financial statements (e.g. in each Quarterly Report on Form 10-Q and Annual Report on Form 10-K) issued for the year of adoption. [842-10-65-1(jj), ASU 2018-11.BC14]



## Observation

### Effect of adoption on the financial statements

13A.2.270 In various forums, including public meetings, that included members of the preparer and practitioner communities, members of the SEC staff have stated that an entity asserting in its financial statements that the effect of adoption of Topic 606 will not be material needs to consider the effect of the new disclosure requirements. That is, even though the basic financial statements may not be materially affected, the information in the significant new disclosures could be a material effect on the financial statements, which include the notes. While this comment has most frequently been made in the context of comments about the adoption of Topic 606, we believe the SEC staff would hold a similar view about an entity's SAB 74 disclosures in relation to the new leases standard.

13A.2.280 We believe some entities, many lessors in particular, may conclude that the effect of Topic 842 on their basic financial statements will not be material but that they will have to make significant new disclosures. Those entities should be cognizant of this guidance from the SEC staff. Meanwhile, lessees and others that anticipate a material effect from adoption should discuss the substantial new Topic 842 disclosure requirements in their pre-adoption SAB 74 disclosures in addition to the other anticipated effects on their financial statements.



## Question 13A.2.130

### Disclosures in comparative periods

#### **Do the lessee, lessor and sale-leaseback disclosure requirements in Topic 842 apply to comparative periods presented in the post-adoption financial statements?**

**Interpretive response:** No, Topic 842 disclosures are not required for comparative annual or interim periods ending before the effective date. However, previous disclosures required to be made under Topic 840 for those periods are required to be included in the entity's post-effective date financial statements.

In all comparative periods presented after the effective date (i.e. annual and interim periods that ended before the effective date) the entity should include the following. [842-10-65-1(jj), ASU 2018-11.BC14]

- Any disclosures previously required under Topic 840 for that comparative period. For example, in its first annual financial statements issued post-adoption of Topic 842, a lessee will include its Topic 840 operating lease rental expense disclosure for the comparative annual periods presented. And if a lessee was required to disclose operating lease rental expense in its 2018 first quarter 10-Q based on the requirements in Topic 270 (interim reporting), it would include that disclosure in its 2019 first quarter 10-Q.

- The prior year-end operating and capital lease commitment maturity tables (if a lessee) as required by paragraphs 840-20-50-2 and 840-30-50-1(b)-(c). These tables would be unchanged from the prior year-end annual financial statements.



### Question 13A.2.140

#### **Loss of EGC status before nonpublic business entity effective date**

#### **When does an EGC that has elected to use the 'all other entities' effective date but loses its EGC status before that date adopt Topic 842?**

**Background:** Assume a calendar year-end entity begins 2021 as an Emerging Growth Company (EGC) but loses EGC status on December 31, 2021. This timing is after the mandatory calendar year-end public business entity (PBE) adoption date for Topic 842 (January 1, 2019), but before the mandatory adoption date for all other calendar year-end entities (January 1, 2022). The first periodic financial statement filing the entity will make after it loses its EGC status will be its Annual Report on Form 10-K for 2021.

In this situation, questions have arisen about transition to Topic 842, including:

- **Question 1:** Upon the loss of EGC status, should the entity adopt Topic 842 with an effective date of January 1, 2021 (beginning of its fiscal year), or is it instead required to adopt Topic 842 as of the date it would have been required to adopt Topic 842 as a PBE (i.e. January 1, 2019) and restate its previous Forms 10-K and 10-Q?
- **Question 2:** Should the entity reflect adoption of Topic 842 in the supplementary quarterly financial data table included in its 2021 Form 10-K?
- **Question 3:** How should the comparative 2021 quarterly information be presented in the entity's fiscal 2022 Form 10-Qs?

**Interpretive response:** The responses to these questions are based on discussions with the SEC staff.

#### **Question 1**

The entity can adopt Topic 842 from January 1, 2021 – i.e. from the beginning of the entity's fiscal year in which it lost EGC status. The entity is not required to adopt Topic 842 as of the date it would have been required to do so as a non-EGC PBE (January 1, 2019). The entity's annual financial statements included in its 2021 Annual Report on Form 10-K will therefore reflect the adoption of Topic 842 from the beginning of its fiscal year.

#### **Question 2**

It depends. In November 2020, the SEC adopted amendments to Regulation S-K to modernize MD&A and other disclosures; see KPMG Hot Topic, [SEC amends Regulation S-K to streamline disclosures](#).

The rule amendments became effective on February 10, 2021. Compliance with the amended rules is required beginning with the fiscal year ending on or after August 9, 2021 – e.g. year ending December 31, 2021 for calendar year-end registrants. [Reg S-K Section II.F]

The amendments to Item 302(a) clarify that an entity is only required to disclose select quarterly financial data in annual filings if there are one or more material retrospective changes to the statements of comprehensive income for any quarters in the two most recent years. If the impacts of Topic 842 adoption were material, the background entity would be required to disclose in its 2021 Form 10-K, for each affected quarterly period and the fourth quarter of the affected year, summarized statement of comprehensive income and earnings per share financial information reflecting those changes.

Under Item 302(a), an entity that loses EGC status would have a retrospective quarterly change that requires materiality analysis. This is because the entity is required to adopt Topic 842 in the 2021 Form 10-K for the full fiscal year, including interim periods within that year. [Reg S-K Item 302(a)]

If the entity that loses EGC status determines that the retrospective changes are material, the affected quarters would include all four quarters because the material retrospective change is as of January 1. [Reg S-K Item 302(a)]

### Question 3

Fiscal 2021 comparative quarterly financial information provided by the entity in its fiscal 2022 Form 10-Qs should be recast to reflect the entity's adoption of Topic 842 as of January 1, 2021.

The comparative 2021 quarterly information presented by the entity in its 2022 Form 10-Qs will not be the same as the information included in its filed 2021 Form 10-Qs, but it will be consistent with the supplementary quarterly financial data included in the entity's 2021 Form 10-K (if any, see Question 2).

No reconciliation between the filed 2021 Form 10-Qs and the 2021 comparative information presented in the 2022 Form 10-Qs is required. However, the entity should disclose its initial application of Topic 842 in Q4 of 2021 with an adoption date of January 1, 2021 in its 2022 Form 10-Qs.

## 13A.3 Transition for lessees



### Excerpt from ASC 842-10

#### 65 Transition and Open Effective Date Information

##### General

> Transition Related to Accounting Standards Updates No. 2016-02, *Leases (Topic 842)*, No. 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*, No. 2018-10, *Codification Improvements to Topic 842, Leases*, No. 2018-11, *Leases (Topic 842): Targeted Improvements*, No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, 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*, No. 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*, No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*, No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*, and No. 2023-01, *Leases (Topic 842): Common Control Arrangements*

**65-1** The following represents the transition and effective date information related to Accounting Standards Updates No. 2016-02, *Leases (Topic 842)*, No. 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*, No. 2018-10, *Codification Improvements to Topic 842, Leases*, No. 2018-11, *Leases (Topic 842): Targeted Improvements*, No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, 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*, No. 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*, No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*, No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*, and No. 2023-01, *Leases (Topic 842): Common Control Arrangements*: [Note: See paragraph 842-10-S65-1 for an SEC Staff Announcement on transition related to Update 2016-02.]

### **Lessees**

#### **Leases previously classified as operating leases under Topic 840**

- k. A lessee shall initially recognize a right-of-use asset and a **lease liability** at the application date as determined in (c).
  - I. 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):
    - 1. The remaining minimum rental payments (as defined under Topic 840).
    - 2. Any amounts **probable** of being owed by the lessee under a **residual value guarantee**.
- m. For each lease classified as an operating lease in accordance with paragraphs 842-10-25-2 through 25-3, a lessee shall initially measure the right-of-use asset at the initial measurement of the lease liability adjusted for both of the following:
  - 1. The items in paragraph 842-20-35-3(b), as applicable.
  - 2. The carrying amount of any liability recognized in accordance with Topic 420 on exit or disposal cost obligations for the lease.
- n. For each lease classified as an operating lease in accordance with paragraphs 842-10-25-2 through 25-3, a lessee shall subsequently measure the right-of-use asset throughout the remaining lease term in accordance with paragraph 842-20-35-3(b). If the initial measurement of the right-of-use

asset in (m) is adjusted for the carrying amount of a liability recognized in accordance with Topic 420 on exit or disposal cost obligations for the lease, the lessee shall apply the recognition and subsequent measurement guidance in Sections 842-20-25 and 842-20-35, respectively, when the right-of-use asset has been impaired.

- o. For each lease classified as a finance lease in accordance with paragraph 842-10-25-2, a lessee shall measure the right-of-use asset as the applicable proportion of the lease liability at the commencement date, which can be imputed from the lease liability determined in accordance with (l). The applicable proportion is the remaining lease term at the 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.
- 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.
- 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.

#### **Leases previously classified as capital leases under Topic 840**

- 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.
  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.
  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).

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.
- s. For each lease classified as an operating lease in accordance with this Topic, a lessee shall do the following:
  1. Derecognize the carrying amount of any capital lease asset and capital lease obligation in accordance with Topic 840 at the application date as determined in (c). Any difference between the carrying amount of the capital lease asset and the capital lease obligation shall be accounted for in the same manner as prepaid or accrued rent.
  2. If an entity elects the transition method in (c)(1) and the lease commenced before the beginning of the earliest period presented in the financial statements or if the entity elects the transition method in (c)(2), recognize a right-of-use asset and a lease liability in accordance with paragraph 842-20-35-3 at the application date as determined in (c).
  3. If an entity elects the transition method in (c)(1) and the lease commenced after the beginning of the earliest period presented in the financial statements, recognize a right-of-use asset and a lease liability in accordance with paragraph 842-20-30-1 at the commencement date of the lease.
  4. Account for the operating lease in accordance with the guidance in Subtopic 842-20 after initial recognition in accordance with (s)(2) or (s)(3).
  5. Write off 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.
- 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.

> Transition Related to Accounting Standards Update No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*

**65-6** The following represents the transition and effective date information related to Accounting Standards Update No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*:

- a. An entity that has not yet adopted the pending content that links to paragraph 842-10-65-1 as of 11/11/2021 shall apply the pending content that links to this paragraph to all new and existing leases when the entity

- first applies the pending content that links to paragraph 842-10-65-1. That entity 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 (as of 11/11/2021) shall:
1. 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 as of the beginning of the fiscal year of adoption.
  2. Apply the pending content that links to this paragraph on a modified retrospective basis to leases affected by the amendments existing as of the beginning of the fiscal year of adoption by adjusting the lease liability, which shall be calculated based on the discount rate and remaining lease term at the beginning of the fiscal year of adoption. An entity shall recognize the amount of the change in the lease liability as an adjustment to the corresponding right-of-use asset, unless:
    - i. The carrying amount of the right-of-use asset is reduced to zero, in which case the entity shall recognize any remaining amount of the adjustment to opening retained earnings at the beginning of the fiscal year of adoption.
    - ii. The adjustment would increase a right-of-use asset that was previously impaired, in which case the entity shall record the adjustment to opening retained earnings at the beginning of the fiscal year of adoption.
- c. An entity within the scope of (b) shall not treat the adoption of the pending content that links to this paragraph as an event that would require the entity to:
1. Remeasure and reallocate the consideration in the contract in accordance with paragraph 842-10-15-36.
  2. Reassess the lease term or a lessee option to purchase the underlying asset in accordance with paragraph 842-10-35-1.
  3. Remeasure the lease payments in accordance with paragraph 842-10-35-4.
  4. Reassess lease classification in accordance with paragraph 842-10-25-1.
- d. An entity within the scope of (b) that has adopted the pending content that links to this paragraph shall disclose the following as of the beginning of the fiscal year of adoption (rather than at the beginning of the earliest period presented):
1. The information required by paragraph 250-10-50-1(a) and (b)(3), if applicable
  2. The recognized amount of changes in lease liabilities and corresponding right-of-use assets resulting from the transition adjustment.

For an entity within the scope of (b), at the date of adoption of the pending content that links to this paragraph, the entity may choose to apply or discontinue using the risk-free rate for any class of underlying asset.

> Transition Related to Accounting Standards Update No. 2023-01, *Leases (Topic 842): Common Control Arrangements*

**65-7** The following represents the transition and effective date information related to the practical expedient in Accounting Standards Update No. 2023-01, *Leases (Topic 842): Common Control Arrangements*:

- a. The pending content that links to this paragraph shall be effective for fiscal years, including interim periods within those fiscal years, beginning after December 15, 2023. Early adoption is permitted in any annual or interim period for which financial statements have not yet been made available for issuance. If an entity adopts the pending content that links to this paragraph in an interim period, it shall adopt that pending content as of the beginning of the fiscal year that includes that interim period.
- b. An entity that adopts the pending content that links to this paragraph concurrently with adopting the pending content that links to paragraph 842-10-65-1 shall apply the pending content that links to this paragraph using the same transition method elected for the pending content that links to paragraph 842-10-65-1.
- c. An entity that adopted the pending content that links to paragraph 842-10-65-1 before adopting the pending content that links to this paragraph shall apply the pending content that links to this paragraph using either of the following two methods:
  1. Prospectively to arrangements that commence or are modified on or after the date that the entity first applies the pending content that links to this paragraph.
  2. Retrospectively to the beginning of the period in which the pending content that links to paragraph 842-10-65-1 was first applied. The pending content that links to this paragraph shall not be applicable for arrangements no longer in place at the date of adoption. Under this transition method:
    - i. If an arrangement previously considered to be a lease continues to be a lease after applying the pending content that links to this paragraph, an entity shall apply the requirements in paragraphs 842-10-25-9 through 25-17 to any changes in the lease resulting from application of the practical expedient in the pending content that links to this paragraph. Any amounts that otherwise would have been recognized in earnings shall be recognized as a cumulative-effect adjustment to opening retained earnings (or net assets of a not-for-profit entity) at the beginning of the earliest period presented in accordance with the pending content that links to paragraph 842-10-65-1.
    - ii. If an arrangement previously not considered a lease becomes a lease after applying the pending content that links to this paragraph, an entity shall account for the arrangement as a new lease.
- d. An entity may document any existing unwritten terms and conditions of an arrangement between entities under common control before the date on which the entity's first interim (if applicable) or annual financial statements are available to be issued in accordance with the pending content that links to this paragraph.

- e. An entity within the scope of (c) shall provide the applicable transition disclosures required by Topic 250 on accounting changes and error corrections, except for the requirements in paragraphs 250-10-50-1(b)(2) and 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 earliest period presented but not before the date on which the pending content that links to paragraph 842-10-65-1 was adopted.
- f. An entity that elects the practical expedient(s) in paragraph 842-10-65-1(f) or (g) is not required to apply either of those practical expedients to common control arrangements for which the pending content that links to this paragraph is being applied.

**65-8** The following represents the transition and effective date information related to the accounting for leasehold improvements associated with leases between entities under common control in Accounting Standards Update No. 2023-01, *Leases (Topic 842): Common Control Arrangements*:

- a. The pending content that links to this paragraph shall be effective for fiscal years, including interim periods within those fiscal years, beginning after December 15, 2023. Early adoption is permitted in any annual or interim period for which financial statements have not yet been made available for issuance. If an entity adopts the pending content that links to this paragraph in an interim period, it shall adopt that pending content as of the beginning of the fiscal year that includes that interim period.
- b. An entity that adopts the pending content that links to this paragraph concurrently with adopting the pending content that links to paragraph 842-10-65-1 may apply the pending content that links to this paragraph using the same transition method elected for the pending content that links to paragraph 842-10-65-1 or may apply the pending content that links to this paragraph using either of the prospective methods specified in (c)(1) and (c)(2) below.
- c. An entity that adopted the pending content that links to paragraph 842-10-65-1 before adopting the pending content that links to this paragraph shall apply the pending content that links to this paragraph using one of the following methods:
  1. Prospectively to all new leasehold improvements recognized on or after the date that the entity first applies the pending content that links to this paragraph.
  2. Prospectively to all new and existing leasehold improvements recognized on or after the date that the entity first applies the pending content that links to this paragraph. An entity that elects this transition approach shall amortize the remaining balance of leasehold improvements existing at the date of adoption of the pending content that links to this paragraph over the remaining useful life of those improvements to the common control group determined at that date.
  3. Retrospectively to the beginning of the period in which the pending content that links to paragraph 842-10-65-1 was first applied. Any leasehold improvements previously amortized or impaired that otherwise would not have been amortized or impaired had the pending content that links to this paragraph been applicable shall be recognized through a cumulative-effect adjustment to the opening balance of retained earnings (or net assets of a not-for-profit entity) at the

beginning of the earliest period presented in accordance with the pending content that links to paragraph 842-10-65-1.

- d. An entity within the scope of (c) shall provide the applicable transition disclosures required by Topic 250 on accounting changes and error corrections, except for the requirements in paragraphs 250-10-50-1(b)(2) and 250-10-50-3. An entity that elects the transition method in (c)(3) shall provide the transition disclosures in paragraph 250-10-50-1(b)(3) as of the beginning of the earliest period presented but not before the date on which the pending content that links to paragraph 842-10-65-1 was adopted.

## **55 Implementation Guidance and Illustrations**

### **General**

- > Implementation Guidance
- > Illustrations of Transition
- • > Illustration of Lessee Transition—Existing Capital Lease

**55-243** Example 28 illustrates lessee accounting for the transition of existing capital leases when an entity elects the transition method in paragraph 842-10-65-1(c)(1).

• • • > 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).

• • > Illustration of Lessee Transition—Existing Operating Lease

**55-248** 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).

• • • > 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.



## Observation

### Implementation guidance and illustrations in Topic 842 not updated for effective date method

13A.3.05 The implementation guidance and illustrations in Topic 842 were not updated to reflect the effective date method. As a result, the illustrative examples in section 842-10-55 still only make reference to "the earliest comparative period presented in the financial statements."

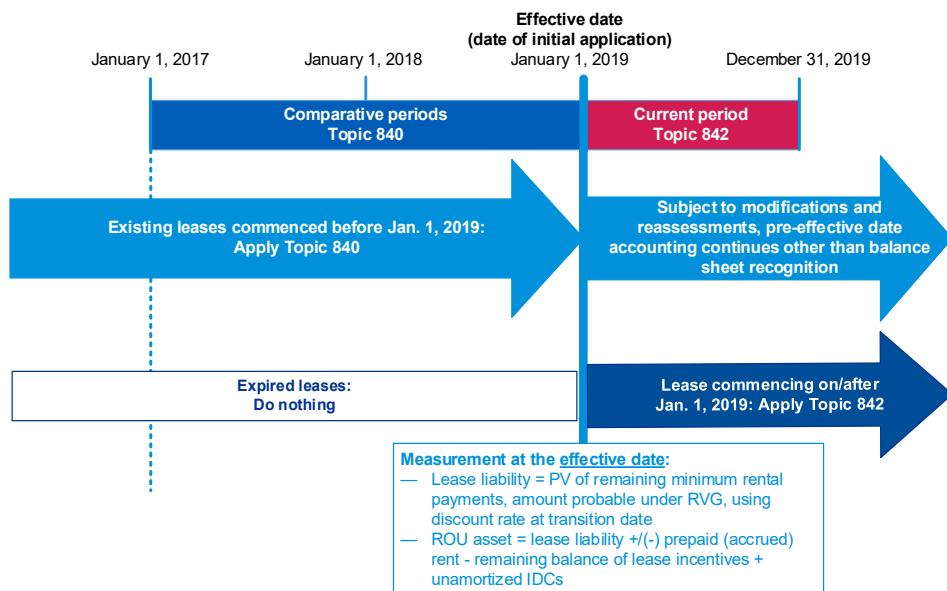
## 13A.3.1 Lessee elects package of practical expedients

13A.3.10 This section discusses the transition requirements for a lessee that elects the package of practical expedients (see section 13A.2.3). Because lease classification is not reassessed in applying the package of practical expedients: [842-10-65-1(f)(2)]

- all existing leases classified as operating leases under Topic 840 will be classified as operating leases under Topic 842; and
- all existing leases classified as capital leases under Topic 840 will be classified as finance leases under Topic 842.

### ***Operating leases under Topic 840***

13A.3.20 The following diagram gives an overview of the transition requirements for an operating lease, which are explained in this section, assuming a public business entity with a calendar year-end.



### **Lease liability initial and subsequent measurement**

13A.3.30 Absent lease modifications or remeasurements, the lease liability is measured as follows, both at the effective date and subsequently – i.e. for the remainder of the lease term. [842-10-65-1(l)]



Note:

1. Minimum rental payments (as defined in Topic 840, see Question 13A.3.10).

13A.3.40 The discount rate for the lease is measured as follows at the effective date. [842-10-65-1(l), 842-20-30-3]

- For all entities, it is the rate implicit in the lease if that rate is readily determinable (see Question 5.6.20).
- If the rate implicit in the lease is not readily determinable:
  - for public business entities, it is the lessee's incremental borrowing rate (see Question 13A.3.50);
  - for all other entities, a risk-free discount rate may be used instead of the lessee's incremental borrowing rate if the lessee elects to do so for the applicable class of underlying asset (see paragraph 5.6.30).

### Question 13A.3.10

#### **Minimum rental payments**

**Do the 'minimum rental payments' in Topic 840 exclude the portion of fixed rental payments attributable to executory costs such as taxes, insurance and maintenance (including CAM)?**

**Interpretive response:** Topic 840 is not clear in this respect. 'Minimum rental payments' is not a defined term in Topic 840 (or the ASC Master Glossary), and there has been diversity in practice.

Some entities accounted for executory costs, when part of the fixed payments in the lease contract, as part of the minimum rental payments for a lease (Approach A), while other entities excluded such amounts from the minimum rental payments (Approach B). For example, in a gross real estate lease, entities following Approach A treated the entire gross periodic payment as a minimum rental payment (and included that amount in their operating lease maturity analysis disclosure), while those following Approach B excluded the portion of the payment that represented executory costs for property taxes, insurance and maintenance from the minimum rental payments for the lease (and excluded that amount from their operating lease maturity analysis disclosure).

For any lease that includes fixed executory costs, the resulting lease liability and ROU asset will be larger measured on the basis of Approach A than they would be (i.e. assuming the same terms and conditions) measured on the basis of Approach B and will also be larger than they would be on the basis of the 'lease payments' as defined in Topic 842 if there were non-lease components.

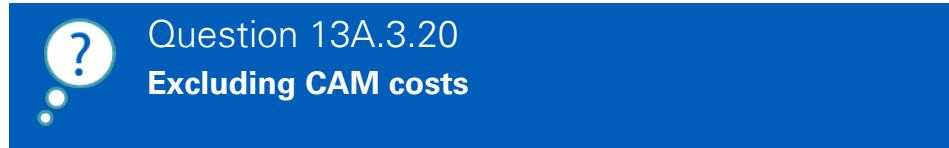
The SEC staff has observed "that the term 'minimum rental payments' is not explicitly defined in ASC 840. As a result, the staff did not object to registrants consistently applying their historical accounting policy conclusions regarding the composition of minimum lease payments when concluding whether executory costs should be included in remaining minimum rental payments for purposes of establishing the lease liability in transition." Consequently, a lessee's application of Approach A or Approach B under Topic 840 may be retained by the lessee when measuring its existing operating leases on transition to Topic 842 in accordance with paragraph 842-10-65-1(l). [\[2017 AICPA conf\]](#)

An entity's approach (A or B) should be disclosed and applied consistently to all of the entity's existing leases that were operating leases under Topic 840.

#### **Changing from one approach to the other**

In mid-2018, the SEC staff additionally communicated that changing one's approach to include or exclude executory costs from 'minimum rental payments' (e.g. changing from Approach A to Approach B) constitutes a change in accounting principle under Topic 250 (accounting changes and error corrections) that must be justified as preferable. [\[250-10-20, 250-10-45-1 – 45-2\]](#)

However, we believe it may be acceptable to switch from Approach B to Approach A without establishing preferability if that change accompanies the lessee's policy election not to separate lease and non-lease components in transition to Topic 842 (see Question 13A.5.10). This is because, in that case, the inclusion of executory costs in the measurement of the lease liability in transition is the result of the lessee electing a new accounting principle created by the issuance of ASU 2016-02, rather than changing an existing accounting principle; this scenario was not considered by the SEC staff. [\[250-10-45-2\(a\)\]](#)



#### **Is it acceptable to exclude only the CAM portion of the 'executory' costs of a lease from the minimum rental payments in transition to Topic 842?**

**Background:** As discussed in Question 13A.3.10, it is acceptable under Topic 840 to either include or exclude executory costs from 'minimum rental payments'. Executory costs include costs of taxes, insurance and maintenance (including CAM). Topic 840 does not differentiate between these types of executory costs. [\[840-10-25-1\]](#)

**Interpretive response:** No. Based on discussions with the SEC staff, we do not believe the transition guidance in Topic 842 permits an approach that would

solely exclude executory costs of maintenance from the minimum rental payments used to measure existing leases in transition.



### Question 13A.3.30

#### **Measurement of lease payments that depend on an index or rate in determining the operating lease liability**

**For existing operating leases with variable lease payments that depend on an index or rate, what index or rate should the lessee use to measure the effective date lease liability?**

**Background:** Topic 840 states, “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 therefore affect the determination of income as accrueable.” [840-10-25-4]

In practice, some entities followed this guidance when making their operating lease disclosures under Topic 840. That is, they continued to measure lease payments that depend on an index or rate (e.g. in disclosing remaining minimum rental payments in accordance with paragraph 840-20-50-2) using the index or rate at lease inception (or the date of the last lease modification that required the entity to reassess classification of the lease) throughout the lease term. However, other entities followed a policy of updating the reference index or rate used to measure lease payments that depend on an index or rate in making their disclosure of future minimum rental payments for operating leases.

**Interpretive response:** Based on discussions with the SEC staff, we understand that the staff would accept an entity continuing its historical accounting policy with respect to using (or not using) updated indices or rates in disclosing its operating lease future minimum rental payments when measuring the effective date lease liability. This would mean:

- An entity that has historically *not* updated reference indices or rates when measuring lease payments that depend on an index or rate to include in the minimum rental payments would follow Approach A outlined below.
- An entity that has historically updated reference indices or rates when measuring lease payments that depend on an index or rate to include in the minimum rental payments would follow Approach B outlined below.

#### **Approach A: Use index or rate indicated by paragraph 840-10-25-4**

Under this approach, regardless of whether the existing operating lease is classified as an operating or a finance lease on transition, the lessee uses the index or rate (e.g. CPI) as of lease inception (or the date of the last lease modification that required the entity to reassess the classification of the lease under Topic 840, if applicable) to determine the amount of variable lease

payments that depend on an index or rate to include in the effective date lease liability.

#### **Leases acquired in a business combination**

As an exception to the above, if an existing operating lease at the effective date was acquired in a business combination, we believe a lessee should use the index or rate as of the later of:

- the acquisition date; or
- the date of the last lease modification that, in accordance with Topic 840, required the lessee to account for the modified lease as a new lease.

#### **Approach B: Use index or rate as of the effective date**

Under this approach, the lessee uses the index or rate (e.g. CPI) as of the effective date to determine the amount of variable lease payments that depend on an index or rate to include in the effective date lease liability.

#### **Changing approach**

An entity that has historically not updated reference indices or rates used to measure lease payments that depend on an index or rate when preparing its operating lease future minimum rental payments disclosure may want to apply Approach B.

The SEC staff has communicated that this would constitute a change in accounting principle under Topic 250 (accounting changes and error corrections) that must be justified as preferable, if material. [250-10-20, 250-10-45-1 – 45-2]

#### **Non-SEC registrants**

We believe the above response applies equally to SEC registrants and entities that are not SEC registrants.



**Question 13A.3.40**

**Foreign exchange rate to use in transition when the lease is not denominated in the entity's functional currency**

**For leases with payments that are not in the lessee's functional currency that commenced before the effective date, what exchange rate should be used to translate the ROU asset?**

**Background:** The ROU asset for any lease (finance or operating) is a nonmonetary asset while the lease liability is a monetary liability. Therefore, 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 ROU asset is remeasured using the exchange rate as of the lease commencement date. [842-20-55-10]

For any capital lease under Topic 840 that commenced before the effective date, and that is classified as a finance lease under Topic 842, the lessee

recognizes at the effective date a finance lease ROU asset and a finance lease liability at the carrying amount of the capital lease asset and the capital lease obligation in accordance with Topic 840 immediately before the effective date. [842-10-65-1(r)(1)]

**Interpretive response:** For any lease liability (finance or operating), it is clear the exchange rate that should be used to translate the lease liability at the effective date is the current rate at that date. This is because, as a monetary liability, a lease liability is always remeasured using the current exchange rate.

For a finance lease ROU asset arising from a capital lease under Topic 840, the lessee will remeasure the ROU asset at the effective date using the same exchange rate used immediately before the effective date (see background). This is because the lessee is required to recognize the finance lease ROU asset at the carrying amount of the capital lease asset and changing the exchange rate would change the carrying amount of the ROU asset in the entity's reporting currency.

While not explicit related to leases transition, we believe the ROU asset for a finance or operating lease that was classified as an operating lease under Topic 840 should be measured in the currency of the lease first. Then that amount should be remeasured into the entity's functional currency using the rate at the effective date. This is because there is guidance in Topic 830 (foreign currency matters) that requires an entity to use the exchange rate on the date that an asset or liability is initially recognized. And before the effective date, no ROU asset was recognized. Initial recognition of ROU assets arising from existing operating leases occurs at the effective date. [830-20-30-1]

See section 6.4.3 for discussion of the exchange rates to be used after initial measurement for an operating lease with payments denominated in a foreign currency.

### Question 13A.3.50



#### Determining the incremental borrowing rate in transition

**For an existing operating lease, should the incremental borrowing rate for that lease consider (1) the remaining lease term and remaining minimum rental payments or (2) the total lease term and total minimum rental payments?**

**Background:** Topic 842 specifies that the discount rate for each existing operating lease should be established at the effective date (if applying the effective date method), which means based on the facts and circumstances (e.g. economic environment and lessee credit standing) as of that date. However, it does not prescribe whether that rate should be based on the remaining lease term and remaining minimum rental payments or the total lease term and total minimum rental payments.

**Interpretive response:** Because Topic 842 is not clear on this question, we believe either approach is acceptable, as long as it is applied consistently as an accounting policy election to all of the lessee's leases in transition and the

policy disclosed. This position was affirmed by the FASB and SEC staffs, the latter in a speech by Michael P. Berrigan, Professional Accounting Fellow, Office of the Chief Accountant, at the 2017 AICPA Conference on Current SEC and PCAOB Developments.

That said, we believe use of the total lease term and total minimum rental payments may be more consistent with the intent of the Board. This is because it is our understanding that the Board's decision to permit lessees to determine the incremental borrowing rate for an existing operating lease as of the effective date, rather than as of lease inception or lease commencement, was a practical accommodation intended to make it easier for lessees to make an estimate they generally did not have to make in accounting for those leases under Topic 840. For example, the Board considered that it might be difficult for a lessee to get third-party information about interest rates as of a date significantly in the past – e.g. obtain a bank quote for a rate the bank would have charged 10 or 15 years ago. In contrast, it would generally be no more difficult to obtain the total lease term and total minimum rental payments than to obtain the remaining lease term and remaining minimum rental payments.

Further, we do not believe the transition provision was intended to substantially change the substance of the implied borrowing. A discount rate based on the remaining term of the lease and the remaining minimum rental payments may differ substantially from the rate that would be determined based on the total lease term and the total lease payments. A discount rate for the lease based on the remaining payments and term may not reflect the economics of the lease and may be inconsistent with the Board's intent that the incremental borrowing rate serve as a practical proxy for the interest rate in the contract. For example, an entity would presumably pay a very different interest rate for a 15-year loan with a principal balance of \$15 million (i.e. assume a 15-year lease term with \$15 million in gross minimum rental payments) than it would for a three-year loan with a beginning principal balance of \$3 million (i.e. a three-year lease with \$3 million in gross minimum rental payments).

### ***ROU asset initial measurement***

13A.3.50 The ROU asset is measured as follows at the effective date. Section 13A.9 addresses additional considerations if the lease was acquired in a business combination. [842-10-65-1(m)]



13A.3.60 Before the amendments in ASU 2016-02, lessees were sometimes required to recognize a liability under Topic 420 (exit or disposal cost obligations) for (1) costs to terminate an operating lease before the end of its term, and/or (2) other costs associated with the operating lease that will continue to be incurred without economic benefit to the entity.

13A.3.70 At the effective date for a lease, any existing Topic 420 liability reduces the initial measurement of the ROU asset recognized for the lease regardless of

whether the lease is classified as an operating lease or as a finance lease under Topic 842. If the lease is an operating lease, the accounting after the effective date is different from other operating leases. The ROU asset is generally amortized on a straight-line basis. The combined straight-line amortization of the ROU asset and the accretion of the lease liability on an effective interest basis each period is recognized as a single operating lease cost for the lease. [842-10-65-1(m) – 65-1(n)]

### ***ROU asset subsequent measurement***

13A.3.80 After initial recognition, the ROU asset is measured using the same lessee subsequent measurement guidance applicable to new operating leases that commence on or after the effective date (see section 6.4.2). [842-10-65-1(n)]



#### Question 13A.3.60

#### **ROU asset abandoned before the effective date**

### **Should a lessee recognize an ROU asset in transition if it has already abandoned the asset before the effective date?**

**Background:** A lessee may have abandoned an ROU asset (see Question 6.5.50) arising from an existing operating lease before the effective date of Topic 842. Despite this, following the transition requirements for the initial measurement of the ROU asset could result in the lessee recognizing the abandoned ROU asset. This is because the transition guidance does not address abandoned ROU asset scenarios and derives the ROU asset for existing operating leases from the lease liability (which will not be zero, even in an abandonment scenario).

**Interpretive response:** No. An ROU asset should not be recognized on transition if it was abandoned before the Topic 842 effective date. If an abandoned ROU asset is measured at an amount greater than zero after applying the transition guidance, a further adjustment should be recorded through equity to reduce the carrying amount of that ROU asset to zero as of the effective date.



#### Question 13A.3.70

#### **Executory costs that are part of Topic 420 liabilities on transition**

### **Are amounts for lessee executory costs (e.g. property taxes) in a Topic 420 liability netted against the ROU asset established on transition?**

**Background:** Before transition to Topic 842, Lessee LE provided legal notice that it will terminate its operating lease of a facility before the conclusion of the contract term.

Based on the terms of the lease contract, in addition to making fixed rental payments, LE is required to make variable property tax payments. Under Topic 420, at the cease-use date, LE recognized a liability for the remaining rental payments and the property tax payments it expected to make over the remaining term for which it will receive no economic benefit.

**Interpretive response:** Yes. Paragraph 842-10-65-1(m) does not envisage separation of a Topic 420 operating lease liability into components – e.g. a component associated with the contractual rental payments and a component related to one or more executory costs, such as an obligation to pay property taxes on the underlying asset. Therefore, the entire Topic 420 liability is netted against the effective date ROU asset, including any portion attributable to expected executory costs for which the lessee will receive no economic benefit, as long as the carrying amount of the ROU asset will not be reduced below zero subsequent to that action (see Question 13A.3.80).



### Question 13A.3.80

#### Transition guidance for Topic 420 liabilities results in negative ROU asset carrying amount

**If netting the existing Topic 420 liability on transition would result in a negative initial measurement of the ROU asset, how is that excess credit accounted for?**

**Background:** The carrying amount of a lessee's Topic 420 liability immediately before the Topic 842 effective date for an existing operating lease may exceed the amount that will be recognized for the lease liability at the effective date. Consequently, measuring the ROU asset in accordance with paragraph 842-10-65-1(m) may result in a negative ROU asset carrying amount.

For example, the Topic 420 liability might include estimated executory costs (e.g. for property taxes or insurance) that the lessee expects to pay over the remaining lease term for which it will receive no economic benefit. However, the lease liability does not include such amounts – either because the costs are variable or because the lessee has historically followed Approach B in Question 13A.3.10.

**Interpretive response:** If netting the Topic 420 liability would create a negative ROU asset carrying amount, we believe the lessee should reduce the carrying amount of the ROU asset to zero and then do one of the following with the remaining amount of the Topic 420 liability:

- **Derecognize the 'excess' Topic 420 liability.** The corresponding entry is an adjustment to equity at the effective date. The costs underlying that excess amount will be recognized through the income statement as they are incurred after the effective date.

Under this approach, the lessee will recognize those costs through the income statement twice: once when the Topic 420 liability was established before the effective date, and again when those costs are actually incurred after the effective date. Operating lease costs are no longer in the scope of Topic 420 from the effective date of Topic 842; therefore this approach

takes the perspective that there is no longer a basis in Topic 420 to recognize the excess amounts.

Proponents of this approach believe that paragraph 842-10-65-1(d) would instruct the lessee to take the excess credit to equity on the effective date and account for the lease-related costs underlying that excess liability that will be incurred after the effective date in the same manner as such costs will be accounted for after the effective date for new leases. [842-10-65-1(d)]

- **Continue to recognize the ‘excess’ Topic 420 liability.** Under this approach, the excess credit is accounted for after the effective date in the same manner as before the effective date. Proponents of this approach note that the FASB stated its intent for lessees to be able to ‘run off’ existing leases in accordance with the requirements in previous GAAP (other than recognizing new ROU assets and lease liabilities for existing operating leases) – see paragraph 13A.2.120. Therefore, it would be inconsistent with that intent to require a lessee to derecognize the excess Topic 420 liability and recognize those costs through the income statement a second time. Proponents further note that it would appear to be inconsistent with the intent of the new standard to *derecognize* existing liabilities when its principal goal was the recognition of previously unrecognized lease liabilities. [ASU 2016-02.Summary, ASU 2016-02.BC390]

Topic 842 does not provide guidance on this type of scenario; therefore, in the absence of additional guidance from the FASB or the SEC staff, we believe either of the above approaches is acceptable as an accounting policy election applied to all of the entity’s leases for which it is a lessee.

### Question 13A.3.90 Existing sublease liabilities under Topic 840

#### How should sublease liabilities recognized under Topic 840 for existing leases be accounted for on initial application of Topic 842?

**Background:** Under Topic 840, if costs expected to be incurred under an operating sublease (e.g. executory costs and either amortization of the leased asset or rental payments on an operating lease) exceed anticipated revenue on the operating sublease, a loss is recognized by the sublessor. [840-20-25-15]

The transition guidance in Topic 842 provides explicit guidance on how to account for existing Topic 420 liabilities in transition (see paragraph 13A.3.70 and Question 13A.3.80), but does not address sublease liabilities recognized in accordance with the Topic 840 guidance in the preceding paragraph.

#### Interpretive response:

##### Existing operating leases

For existing operating leases, regardless of how classified under Topic 842 (i.e. as operating or finance leases), we believe any of the following approaches is

acceptable as an accounting policy election applied to all of an entity's leases for which it is the lessee.

- **By analogy to transition for Topic 420 liabilities (Topic 420 analogy approach).** Net existing sublease liabilities against the ROU asset for existing operating leases on initial application of Topic 842 by analogy to the guidance on Topic 420 liabilities in paragraph 842-10-65-1(m). Proponents of this approach believe these two types of liabilities are similar in nature and note that the FASB staff has, in discussions about impairment of ROU assets in transition (see Question 13A.3.110, for example), also equated these two types of liabilities. Therefore, because Topic 842 does not provide any guidance on accounting for sublease liabilities recognized under paragraph 840-20-25-15 on initial application of Topic 842, we believe analogizing to the Topic 420 liability transition guidance is reasonable.

A lessee applying this analogy will apply the guidance in *both* paragraphs 842-10-65-1(m) and 65-1(n). See paragraph 13A.3.70 and Questions 13A.3.70 and 13A.3.80.

- **Eliminate the sublease liability through equity (elimination approach).** Write off the existing sublease liability through equity as part of the cumulative effect transition adjustment at the effective date. Topic 842 does not have sublease loss guidance like what existed in Topic 840. Therefore, proponents of this approach believe there is no longer a basis in Topic 842 upon which to continue to recognize the sublease liability. Proponents of this approach believe that paragraph 842-10-65-1(d) would instruct the lessee to write off the liability to equity at the effective date. [842-10-65-1(d)]

A lessee adopting this approach would consider whether the loss-making sublease means the newly recognized ROU asset is impaired (if the ROU asset is the only asset in its asset group). We believe at the point in time the sublease was entered into, the ROU asset may have become its own asset group (see Question 6.5.60); and if so, recognizing any impairment of the ROU asset that exists as a result of entering into the loss-making sublease through effective date equity would not conflict with the responses to Questions 13A.3.110 and 13A.3.120. However, if a Topic 360 impairment is not taken on the effective date, the effect of this approach will be that the sublease loss is taken against current period earnings after the effective date – i.e. the sublease loss recognized previously under Topic 840 will be taken a second time through earnings in periods post-adoption.

In the case of an impairment resulting from this approach, we believe the lessee's accounting on and after the effective date may be very similar in result to applying the Topic 420 analogy approach. If there is not an impairment of the ROU asset, we believe it may be unlikely that a lessee will elect this approach given the requirement to effectively recognize the sublease loss twice.

- **Retain separate recognition of the sublease liability (separate recognition approach).** The lessee would:
  - continue to recognize the Topic 840 sublease liability separate from the new lease liability recognized in transition; and

- reduce the liability over the shorter of (1) the remaining head lease term or (2) the remaining term of the loss-making sublease, in a pattern consistent with the recognition of lease cost (operating leases) or amortization of the ROU asset (finance leases) over that same period of time.

In contrast to the Topic 420 analogy approach, a lessee electing this approach will not recognize the effect of the sublease loss over the entire head lease term if the sublease term is shorter than that of the head lease. Additionally, head lease cost will continue to be recognized on a straight-line basis after the effective date, rather than on a front-loaded basis as would occur if analogizing to the Topic 420 liability requirements.

Proponents of this approach note that the FASB stated its intent for lessees to be able to 'run off' existing leases in accordance with the requirements in previous GAAP (other than recognizing new ROU assets and lease liabilities for existing operating leases) – see paragraph 13A.2.120, and that this approach would be most consistent with that intent. [ASU 2016-02.Summary, ASU 2016-02.BC390]

Under this approach, if the lease is modified or remeasured on or after the effective date, we believe the 'run-off' allowance would end. Therefore, the remaining carrying amount of the sublease liability would be written off. We believe the offsetting entry would be first to the modified or remeasured ROU asset (dr. sublease liability, cr. ROU asset); and second to a gain. That is, a gain should only result if the adjustment would reduce the carrying amount of the ROU asset below zero. This accounting would be the most consistent with the generally prospective accounting under Topic 842 for lease modifications and remeasurements.

### **Existing capital leases classified as finance leases under Topic 842**

The transition guidance in Topic 842 for existing capital leases classified as finance leases under Topic 842 requires the new finance lease ROU asset and finance lease liability to equal the carrying amount of the existing capital lease asset and capital lease obligation. We believe this explicit requirement precludes reducing the carrying amount of the existing capital lease asset by the amount of any Topic 840 sublease liability. [842-10-65-1(r)]

Consequently, we believe a lessee is required to adopt either the 'separate recognition' or 'elimination' approaches outlined for existing operating leases.

If applying the elimination approach, we believe the requirement to measure the finance lease ROU asset at the carrying amount of the prior capital lease asset precludes recognizing an additional Topic 360 impairment as part of the transition date cumulative effect adjustment.

If applying the separate recognition approach, the lessee will:

- continue to recognize the separate Topic 840 sublease liability; and
- reduce the liability over the shorter of the (1) remaining head lease term or (2) remaining term of the loss-making sublease, in a pattern consistent with the pattern of amortization of the ROU asset over that same period of time.

### Existing capital leases classified as operating leases under Topic 842

For existing capital leases classified as operating leases under Topic 842, we believe the lessee should follow the 'elimination approach'. This is because the goal of the transition requirements for these leases is to effectively reset the lease so that the accounting at and after the effective date is consistent with that for any new operating lease that commences on or after the effective date (see paragraphs 13A.3.200 – 13A.220). To that end, we believe any new operating lease subject to a loss-making sublease will be considered for impairment under Topic 360 (see section 6.5.2); and if the ROU asset is not impaired, the lessee will account for the sublease income deficits through earnings each period as incurred.



#### Question 13A.3.110

#### Effects of Topic 360 impairments before the effective date

### What effect do prior impairments under Topic 360 have on the initial recognition of ROU assets for existing operating leases?

**Interpretive response:** None, unless the circumstances discussed in Question 13A.3.130 exist.

At a November 2016 FASB meeting, the Board affirmed the view expressed by the FASB staff that lessees should not begin applying the long-lived asset impairment requirements in Topic 360 (property, plant, and equipment) to new ROU assets until the effective date of Topic 842. This includes ROU assets that are part of an asset group that was previously impaired, except as discussed in Questions 13A.3.90 and 13A.3.130.

The FASB staff believes that it was the Board's intent that, in general, lessees should only adjust the carrying amount of operating lease ROU assets for the following, both of which were applicable to operating leases under Topic 840:

- any liabilities recognized in accordance with the contract termination costs guidance in Topic 420; or
- the sublease loss guidance in paragraph 840-20-25-15. However, see Question 13A.3.90 for sublease liabilities recognized under paragraph 840-20-25-15; we do not believe offsetting of those liabilities against the ROU asset is *required*.

The Board did not intend for lessees to have to go back in time and evaluate what effect operating lease ROU assets would have had on Topic 360 impairment assessments before the effective date (see Question 13A.3.120).



### Question 13A.3.120

#### **Transition impact on prior asset group impairments**

### **Should a lessee's prior accounting for a long-lived asset subject to impairment under Topic 360 be changed as a result of the transition to Topic 842?**

**Background:** The recognition of operating lease ROU assets will increase the number and carrying amount of the long-lived assets in the asset group.

For example, an asset group with 50 long-lived assets that have an aggregate carrying amount of \$1 million at the date a previous asset group impairment was recorded may have had 65 long-lived assets with an aggregate carrying amount of \$1.2 million if the operating lease ROU assets had been recognized in the past. This may have affected either or both:

- the amount of the impairment that was recorded – e.g. the amount of the impairment may have been limited to the amount that would reduce the carrying amount of the long-lived assets in the group to zero; if additional long-lived assets (ROU assets) were in the asset group, the impairment charge may have been greater (see Question 13A.3.130).
- the allocation of the impairment to the long-lived assets in the asset group – i.e. even if the total amount of the impairment did not change, the amount of the impairment allocated to each asset in the group would differ if there were additional assets in the group.

**Interpretive response:** No. At a November 2016 FASB meeting, the Board affirmed the view expressed by the FASB staff that lessees should not alter their previous accounting for long-lived assets as a result of transitioning to Topic 842.

This means that impairment amounts previously allocated to a long-lived asset (e.g. an item of property, plant or equipment or a finite-lived intangible asset), and subsequent accounting resulting from the amount of that impairment (e.g. depreciation or amortization of the long-lived asset), should not be changed as a result of initially applying Topic 842.



### Question 13A.3.130

#### **Recognizing 'hidden' ROU asset impairments at the effective date**

### **Can a 'hidden' impairment of an ROU asset arising from a Topic 840 operating lease be recognized through equity at the effective date?**

**Background:** A 'hidden impairment' refers to either:

- where a Topic 360 asset group was fully impaired before the effective date (i.e. all of the long-lived assets in the group were written down by the

- maximum allowable amount under Topic 360 at the time of the impairment) and an additional impairment charge would have been recorded on that asset group before the effective date had the operating lease ROU asset(s) been recognized at that date; or
- where a Topic 360 asset group would have included only one or more ROU assets that were not recognized under Topic 840, and an impairment charge would have been recorded on that asset group before the effective date had the operating lease ROU asset(s) been recognized under Topic 840.

**Interpretive response:** Based on the FASB staff views outlined in Questions 13A.3.110 and 13A.3.120, we believe it would be acceptable for a lessee not to consider the impairment guidance in Topic 360 as it relates to newly recognized ROU assets until the effective date of Topic 842 and to recognize any impairment that exists as of that date, including any 'hidden impairment', and regardless of whether the condition or event giving rise to that impairment occurred before the effective date, as a charge to adoption-year income or loss.

However, the FASB staff has expressed the view that it would be acceptable to recognize a hidden impairment of an ROU asset arising from an existing operating lease at the effective date. In that case, the amount of the additional impairment (i.e. the hidden impairment plus any additional amount of impairment that presently exists at the effective date) would be taken through an adjustment to equity at the effective date, with a corresponding reduction to the carrying amount(s) of the ROU asset(s). Note that no amount of past hidden impairment should be taken at the effective date if the asset group to which the ROU asset belongs is not impaired at the effective date based on an effective date Topic 360 analysis.

We believe this interpretation does not conflict with the responses to Questions 13A.3.110 and 13A.3.120 because it (1) would not affect any prior accounting for other long-lived assets and (2) reflects a unique circumstance where this adjustment is effectively the result of a past impairment assessment and preexisting conditions of impairment, rather than one triggered primarily by the recognition of new operating lease ROU assets.



### Question 13A.3.140

#### Amortization period for leasehold improvements previously acquired in a business combination

### What amortization period should a lessee assign in transition to leasehold improvements previously acquired in a business combination?

**Background:** Topic 840 required the amortization period at the acquisition date to be the shorter of (1) the remaining useful life of the leasehold improvements and (2) *a period equal to the sum of the non-cancellable period of the lease plus renewal periods reasonably assured of exercise.* [840-10-35-9]

**ASC 840-10-35-9**

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 lease term) at the date of acquisition.

Topic 842 requires the amortization period at the acquisition date to be the shorter of the (1) remaining useful life of the leasehold improvements and (2) *remaining lease term*. [842-20-35-13]

Although Topic 842 and Topic 840 use different words, the amortization period for acquired leasehold improvements that results from applying both Topics is the same – i.e. one that is the shorter of (1) their remaining useful life and (2) a period that includes the non-cancellable period of the lease plus renewal periods the acquirer is reasonably certain to exercise.

- Topic 840 used its particular *italicized* language because, before the adoption of Topic 842, an acquirer did not reassess the acquiree's lease term as part of acquisition accounting.
- In contrast, Topic 842 refers to the 'remaining lease term' because the acquirer *does* reassess the lease term of an acquired lease, as if it was a new lease of the acquirer, at the acquisition date. [805-20-30-24]

Because Topic 840 did not reassess the lease term of an acquired lease, the remaining lease term at the acquisition date could be shorter than the amortization period for the acquired leasehold improvements. This cannot occur under Topic 842.

### **Background example**

Company AR acquired Lessee LE in a business combination on January 1, 2018 – before AR's adoption of Topic 842 on January 1, 2019 – with the following facts.

- LE is the lessee in a building lease with a remaining lease term of three years immediately before the acquisition. The lease includes two five-year lessee renewal options that LE determined it was not reasonably assured to exercise; therefore, the options were excluded from LE's determination of the lease term. The lease does not include an option for LE to purchase the building.
- LE has constructed leasehold improvements, which it owns, that have a 15-year remaining useful life at the acquisition date.
- The following applied in AR's acquisition accounting for the acquired lease when Topic 840 was in effect.
  - AR did not reassess the lease term determined by LE.
  - AR concluded that the leasehold improvements should be amortized over a period of eight years from the acquisition date. Eight years includes the three-year remaining non-cancellable period of the lease plus the first of the five-year lessee renewal options, for which AR concluded exercise was reasonably assured upon acquisition. Despite

the longer useful life of the leasehold improvements, AR concluded that exercise of the second five-year renewal option was not reasonably assured at the acquisition date.

- At the effective date of January 1, 2019, AR concludes that it is reasonably certain to exercise both five-year renewal options if it elects the use-of-hindsight practical expedient (see section 13A.2).

**Interpretive response:** We believe the response to this question differs depending on whether the entity elects the use-of-hindsight practical expedient.

### Entity does not elect to use hindsight

In general, we believe transition provisions are designed to migrate an entity's legacy accounting to that which would exist had the entity been applying the new guidance all along.

Applying this logic to the background example, had AR been applying Topic 842's requirements at the acquisition date, it would have concluded, just as it did under Topic 840, that the amortization period for the acquired leasehold improvements was eight years. This is because AR would have concluded that the remaining lease term, assessed as if the acquired lease was a new lease on the acquisition date, was eight years. Eight years is shorter than the 15-year remaining useful life of the leasehold improvements, so eight years would have been the amortization period.

Because Topic 842 and Topic 840 would result in the same amortization period, and AR did not elect to use hindsight in transition, AR simply retains the eight-year amortization period in transition to Topic 842 (seven years remaining at the effective date).

Further, this approach also considers the Board's stated intent for lessees to, in effect, have the option to 'run off' existing leases in accordance with the requirements of previous GAAP – other than recognizing new ROU assets and lease liabilities for existing operating leases (see paragraph 13A.2.120). This approach, which retains the entity's amortization period for the leasehold improvements at the effective date, is consistent with that intent. [IASU 2016-02.Summary, ASU 2016-02.BC390](#)

### Entity elects to use hindsight

Again using the background example, if AR elected the use-of-hindsight practical expedient in transition, AR would account for the acquired lease in transition as if it had always (since the acquisition date) assessed the lease term as 13 years (rather than eight years).

In contrast to an entity that does not elect hindsight, we believe an entity electing to use hindsight is also deciding to abandon 'running off' its old lease accounting. An entity electing hindsight is choosing to reassess, rather than continue to use, legacy accounting judgments such as the lease term.

Therefore, we believe AR would also adjust the amortization period of the acquired leasehold improvements – i.e. AR would adjust its accounting for those leasehold improvements as if it had originally assigned a 13-year amortization period to those improvements (rather than eight years). This will result in a cumulative-effect adjustment recognized through equity at the effective date.

### Post-effective date accounting for acquired leasehold improvements

Regardless of whether it elected the use-of-hindsight practical expedient in transition, after transition an acquirer will change the amortization period for acquired leasehold improvements if either:

- the lease term changes – through either reassessment or modification (not accounted for as a separate contract) – if the remaining lease term is the amortization period under paragraph 842-20-35-12; or
- the useful life of the leasehold improvements changes and the remaining useful life is (or becomes, as a result of a decrease to the useful life) the amortization period under paragraph 842-20-35-12.

In that case, the change in amortization period is accounted for prospectively in accordance with Topic 250 (accounting changes and error corrections). [250-10-45-17 – 45-20]



#### Example 13A.3.10

##### **Lessee transition for an existing operating lease with package of practical expedients elected – Approach A in Question 13A.3.10**

###### **Scenario 1: Lease is not modified or remeasured on or after the effective date**

The following summarizes relevant information about Lessee LE's lease of office space.

Commencement date of the lease:	January 1, 2016
Lease term:	5 years
Rental payments (annual, paid in arrears), which represent the minimum rental payments under Topic 840: <sup>1</sup>	\$28,000 first two years, \$29,000 thereafter
Estimated amount of annual payments related to reimbursing the lessor's costs of property taxes, insurance, and CAM that are <i>included</i> in the above minimum rental payments: <sup>1</sup>	\$1,500 property taxes \$1,000 insurance \$1,000 CAM
Lease classification at inception under Topic 840:	Operating lease
Initial direct costs, amortized on a straight-line basis over the lease term:	\$1,500
Note:	
1.	In this example, LE has <b>included</b> fixed executory costs in the minimum rental payments when applying Topic 840 and is consistently applying this policy in transition – i.e. LE has applied Approach A discussed in Question 13A.3.10.

Because LE elected the package of practical expedients, it does not reassess whether the contract is or contains a lease, whether classification of the lease would be different under Topic 842, or whether the unamortized initial direct costs at January 1, 2019 would meet the definition of initial direct costs under Topic 842.

### Worksheet at January 1, 2019 (the effective date)

At January 1, 2019, LE's incremental borrowing rate is 5.0% (see section 5.6 and Question 13A.3.50).

Step	Amounts debit/(credit)	Notes
Recognize lease liability	\$(53,923)	Remaining minimum rental payments (\$29,000 for each of 2019 and 2020) discounted at 5.0%
Recognize ROU asset	53,723	Sum of lease liability recognized and \$600 of unamortized IDCs, less \$800 accrued rent liability
Derecognize accrued rent	800	Balance at effective date under Topic 840
Derecognize unamortized IDCs	(600)	Balance at effective date under Topic 840
<b>Adjustment to equity</b>	<b>\$ -</b>	N/A

### Subsequent accounting for the lease

LE subsequently measures the lease liability and ROU asset through the end of the lease term in a manner similar to how it determined the lease liability and ROU asset at January 1, 2019; unless the lease is modified or there is a remeasurement of the lease liability.

LE does not modify the lease and does not have to remeasure the lease liability on or after the effective date. There is also no impairment of the ROU asset through the remainder of the lease term.

### Balance sheet

LE recognizes the following amounts in its balance sheet for its lease of office space through the end of the lease term.

Year ended	ROU asset arising from operating lease	Lease liability arising from operating lease
Dec. 31, 2019 <sup>1</sup>	\$27,519	\$27,619
Dec. 31, 2020	-	-
<b>Note:</b>		
1. Because LE elected the effective date method, no ROU asset or lease liability is presented in the comparative December 31, 2018 balance sheet.		

### Income statement<sup>1</sup>

LE recognizes the following amounts in its income statement for its lease of office space through the end of the lease term.

Year ended	Operating lease cost
Dec. 31, 2019 <sup>2</sup>	\$28,900
Dec. 31, 2020	28,900

**Notes:**

1. A lessee continues to present lease cost in a manner consistent with its presentation under Topic 840 (e.g. SG&A expenses).
2. \$28,600 (total minimum rental payments of \$143,000 / 5 years) + \$300 (amortization of initial direct costs of \$1,500 / 5 years).

**Scenario 2: Lease is modified after the effective date**

Changing the facts of Scenario 1, on January 1, 2020 LE modifies the lease to extend the lease term for two additional years. The original lease agreement did not include any renewal options.

As a result, LE applies the lease accounting guidance under Topic 842 beginning on the effective date of the modification (January 1, 2020). Because the modification increases the lease term only, it does not grant LE an additional right of use, and therefore the modification cannot be accounted for as a separate contract. Accordingly, LE adjusts the original lease liability and records an equal and offsetting change to the existing ROU asset. The following summarizes relevant information for the remeasurement of the lease liability.

Extension period:	2 years
Remaining lease term, including the extension:	3 years
Annual, fixed payments during extension period of 2 years (paid in arrears):	\$30,000
Fixed payment for the remaining 1 year of the original lease term (paid in arrears):	\$29,000
Estimated amount of the remaining annual payments related to reimbursing the lessor's costs of property taxes, insurance and CAM:	\$1,750 property taxes \$1,000 insurance \$1,050 CAM
Additional initial direct costs associated with the lease modification:	None

At the effective date of the modification, \$300 of the initial direct costs from the initial lease remain unamortized.

**Lease liability remeasurement**

In this example, LE identifies only one difference between Topic 840 and Topic 842 that affects the remeasurement of the lease liability and the ROU asset.

- Under Topic 840 (if applying Approach A in Question 13A.3.10), the minimum rental payments (which are used to measure the lease liability and the ROU asset before the modification) included fixed amounts that were intended to reimburse the lessor's costs of property taxes, insurance and CAM. There were no non-lease components under Topic 840.
- Under Topic 842, CAM is a non-lease component (a non-lease service provided to LE by LR). Fixed payments required by the contract are allocated between the lease component (i.e. the right to use the asset) and the non-lease component (CAM) on a relative stand-alone price basis. Therefore, a portion of what LE accounted for as the 'minimum rental

payments' under Topic 840 (i.e. the fixed payments attributable to CAM) will not be part of the 'lease payments' for the modified lease under Topic 842. Assume that this allocation is 95% to the lease component and 5% to CAM.

LE remeasures the lease liability based on:

- one remaining lease payment of \$27,550 (for the remainder of the original lease term), which is 95% of the total fixed payment; the remaining 5% (\$1,450) is allocated to the CAM non-lease component; and
- two additional lease payments of \$28,500 for the extension period, which is 95% of the total fixed payment; the remaining 5% (\$1,500) is allocated to the CAM non-lease component.

LE discounts the lease payments at its January 1, 2020 incremental borrowing rate of 5.5%. This results in a remeasured lease liability of \$75,991, or an increase of \$48,372 compared to the lease liability balance immediately before the effective date of the modification.

### Journal entry

LE records the following journal entry at the effective date of the modification.

	Debit	Credit
ROU asset	48,372	
Lease liability		48,372
<i>To remeasure ROU asset and lease liability following lease modification.</i>		

### Lease classification

LE reassesses lease classification as of the effective date of the modification and determines that the modified lease is still classified as an operating lease. This reassessment is based on facts and circumstances at that date – e.g. the remaining economic life and fair value of the underlying asset at that date.

### Subsequent accounting for the lease

LE calculates the remaining lease cost for the lease as follows.

Total lease payments (including those paid and those not yet paid), reflecting the adjustment resulting from the lease modification	
12/31/16    12/31/17    12/31/18    12/31/19    12/31/20    12/31/21    12/31/22	
\$28,000    \$28,000    \$29,000    \$29,000    \$27,550    \$28,500    \$28,500	\$198,550
Plus: Total initial direct costs attributable to the lease	1,500
Less: Periodic lease cost recognized in prior periods calculated as (straight-line rental expense of \$28,600 × 4 periods) plus (amortization of initial direct costs of \$1,200)	(115,600)
<b>Remaining lease cost for the lease</b>	<b>\$ 84,450</b>

LE recognizes a single lease cost, calculated so that the remaining cost of the lease is allocated over the remaining lease term on a straight-line basis (i.e. \$28,150 per year for the remaining three years).

LE prospectively accounts for the lease liability and ROU asset from the effective date of the modification using the guidance in Topic 842 for an operating lease.

### **Balance sheet**

LE recognizes the following amounts in its balance sheet for its lease of equipment through the end of the revised lease term.

Year ended	ROU asset arising from operating lease	Lease liability arising from operating lease
Dec. 31, 2020	\$51,921	\$52,620
Dec. 31, 2021	26,665	27,014
Dec. 31, 2022	-	-

### **Income statement<sup>1</sup>**

LE recognizes the following amounts in its income statement for its lease of office space through the end of the lease term.

Year ended	Operating lease cost
Dec. 31, 2020	\$28,150
Dec. 31, 2021	28,150
Dec. 31, 2022	28,150

Note:

1. A lessee continues to present lease cost in a manner consistent with its presentation under Topic 840 (e.g. SG&A expenses).



### **Example 13A.3.20**

#### **Lessee transition for an existing operating lease with package of practical expedients elected – Approach B in Question 13A.3.10**

##### **Scenario 1: Lease is not modified or remeasured on or after the effective date**

The following summarizes relevant information about Lessee LE's lease of office space.

Commencement date of the lease:	January 1, 2016
Lease term:	5 years
Rental payments (annual, paid in arrears):	\$28,000 first two years, \$29,000 thereafter

Estimated amount of annual payments related to reimbursing the lessor's costs of property taxes, insurance, and CAM that are included in the above rental payments:	\$1,500 property taxes \$1,000 insurance \$1,000 CAM
Minimum rental payments under Topic 840: <sup>1</sup>	\$24,500 first two years, \$25,500 thereafter
Lease classification at inception under Topic 840:	Operating lease
Initial direct costs, amortized on a straight-line basis over the lease term:	\$1,500
Note:	
1.	In this example, LE has <i>excluded</i> fixed executory costs from the minimum rental payments when applying Topic 840 and is consistently applying this policy in transition – i.e. LE has applied Approach B discussed in Question 13A.3.10.

Because LE elected the package of practical expedients, it does not reassess whether the contract is or contains a lease, whether classification of the lease would be different under Topic 842, or whether the unamortized initial direct costs at January 1, 2019 would meet the definition of initial direct costs under Topic 842.

### Worksheet at January 1, 2019 (the effective date)

At January 1, 2019, LE's incremental borrowing rate is 5.0% (see section 5.6 and Question 13A.3.50).

Step	Amounts debit/(credit)	Notes
Recognize lease liability	\$(47,414)	Remaining minimum rental payments (\$25,500 for each of 2019 and 2020) discounted at 5.0%
Recognize ROU asset	47,214	Sum of lease liability recognized and \$600 of unamortized IDCs, less \$800 accrued rent liability
Derecognize accrued rent	800	Balance at transition under Topic 840
Derecognize unamortized IDCs	(600)	Balance at transition under Topic 840
<b>Adjustment to equity</b>	<b>\$ - N/A</b>	

### Subsequent accounting for the lease

LE subsequently measures the lease liability and ROU asset through the end of the lease term in a manner similar to how it determined the lease liability and ROU asset at January 1, 2019; unless the lease is modified or there is a remeasurement of the lease liability.

LE does not modify the lease and does not have to remeasure the lease liability on or after the effective date. There is also no impairment of the ROU asset through the remainder of the lease term.

### Balance sheet

LE recognizes the following amounts in its balance sheet for its lease of office space through the end of the lease term.

Year ended	ROU asset arising from operating lease	Lease liability arising from operating lease
Dec. 31, 2019 <sup>1</sup>	24,185	24,285
Dec. 31, 2020	-	-

Note:

- Because LE elected the effective date method, no ROU asset or lease liability is presented in the comparative December 31, 2018 balance sheet.

### Income statement<sup>1</sup>

LE recognizes the following amounts in its income statement for its lease of office space through the end of the lease term.

Year ended	Operating lease cost
Dec. 31, 2019 <sup>2</sup>	25,400
Dec. 31, 2020	25,400

Notes:

- A lessee continues to present lease cost in a manner consistent with its presentation under Topic 840 (e.g. SG&A expenses).
- \$25,100 (total minimum rental payments of \$125,500 / 5 years) + \$300 (amortization of initial direct costs of \$1,500 / 5 years).

### Scenario 2: Lease is modified after the effective date

Changing the facts of Scenario 1, on January 1, 2020 LE modifies the lease to extend the lease term for two additional years. The original lease agreement did not include any renewal options.

As a result, LE applies the lease accounting guidance under Topic 842 beginning on the effective date of the modification (January 1, 2020). Because the modification increases the lease term only, it does not grant LE an additional right of use, and therefore the modification cannot be accounted for as a separate contract. Accordingly, LE adjusts the original lease liability and records an equal and offsetting change to the existing ROU asset. The following summarizes relevant information for the remeasurement of the lease liability.

Extension period:	2 years
Remaining lease term, including the extension:	3 years
Annual, fixed payments during extension period of 2 years (paid in arrears):	\$30,000
Fixed payment for the remaining 1 year of the original lease term (paid in arrears):	\$29,000
Estimated amount of the remaining annual payments related to reimbursing the lessor's costs of property taxes, insurance and CAM:	\$1,750 property taxes \$1,000 insurance \$1,050 CAM
Additional initial direct costs associated with the lease modification:	None

At the effective date of the modification, \$300 of the initial direct costs remain unamortized.

### Lease liability remeasurement

In this example, LE identifies only one difference between Topic 840 and Topic 842 that affects the remeasurement of the lease liability and the ROU asset:

- Under Topic 840 (if applying Approach B in Question 13A.3.10), the minimum rental payments (which are used to measure the lease liability and the ROU asset before the modification) excluded fixed amounts that were intended to reimburse the lessor's costs of property taxes, insurance and CAM, while the 'lease payments' under Topic 842 generally include at least a portion of such amounts. There were no non-lease components of this contract under Topic 840.
- Under Topic 842, the CAM is a non-lease component (a non-lease service provided to LE by LR). Fixed payments required by the contract are allocated between the lease component (i.e. the right to use the asset) and the non-lease component (CAM) on a relative stand-alone price basis. Therefore, the portion of the consideration in the contract attributable to CAM will not be part of the 'lease payments' for the modified lease under Topic 842. Assume that this allocation is 95% to the lease component and 5% to CAM.

LE remeasures the lease liability based on:

- one remaining lease payment of \$27,550 (for the remainder of the original lease term), which is 95% of the total fixed payment; the remaining 5% (\$1,450) is allocated to the CAM non-lease component; and
- two additional lease payments of \$28,500 for the extension period, which is 95% of the total fixed payment; the remaining 5% (\$1,500) is allocated to the CAM non-lease component.

LE discounts the lease payments at its January 1, 2020 incremental borrowing rate of 5.5%. This results in a remeasured lease liability of \$75,991, or an increase of \$51,706 compared to the lease liability balance immediately before the effective date of the modification.

### Journal entry

LE records the following journal entry at the effective date of the modification.

	Debit	Credit
ROU asset	51,706	
Lease liability		51,706
<i>To remeasure ROU asset and lease liability following lease modification.</i>		

### Lease classification

LE reassesses lease classification as of the effective date of the modification and determines that the modified lease is still classified as an operating lease.

### Subsequent accounting for the lease

LE calculates the remaining lease cost for the lease as follows.

Total lease payments (including those paid and those not yet paid), reflecting the adjustment resulting from the lease modification							
12/31/16	12/31/17	12/31/18	12/31/19	12/31/20	12/31/21	12/31/22	
\$24,500	\$24,500	\$25,500	\$25,500	\$27,550	\$28,500	\$28,500	\$184,550
Plus: Total initial direct costs attributable to the lease							1,500
Less: Periodic lease cost recognized in prior periods calculated as (straight-line rental expense of $\$25,100 \times 4$ periods) plus (amortization of initial direct costs of \$1,200)							(101,600)
<b>Remaining lease cost for the lease</b>							<b>\$ 84,450</b>

LE recognizes a single lease cost, calculated so that the remaining cost of the lease is allocated over the remaining lease term on a straight-line basis (i.e. \$28,150 per year for the remaining three years).

LE prospectively accounts for the lease liability and ROU asset from the effective date of the modification using the guidance in Topic 842 for an operating lease.

### Balance sheet

LE recognizes the following amounts in its balance sheet for its lease of equipment through the end of the revised lease term.

Year ended	ROU asset arising from operating lease	Lease liability arising from operating lease
Dec. 31, 2020	\$51,921	\$52,620
Dec. 31, 2021	26,665	27,014
Dec. 31, 2022	-	-

### Income statement<sup>1</sup>

LE recognizes the following amounts in its income statement for its lease of office space through the end of the lease term.

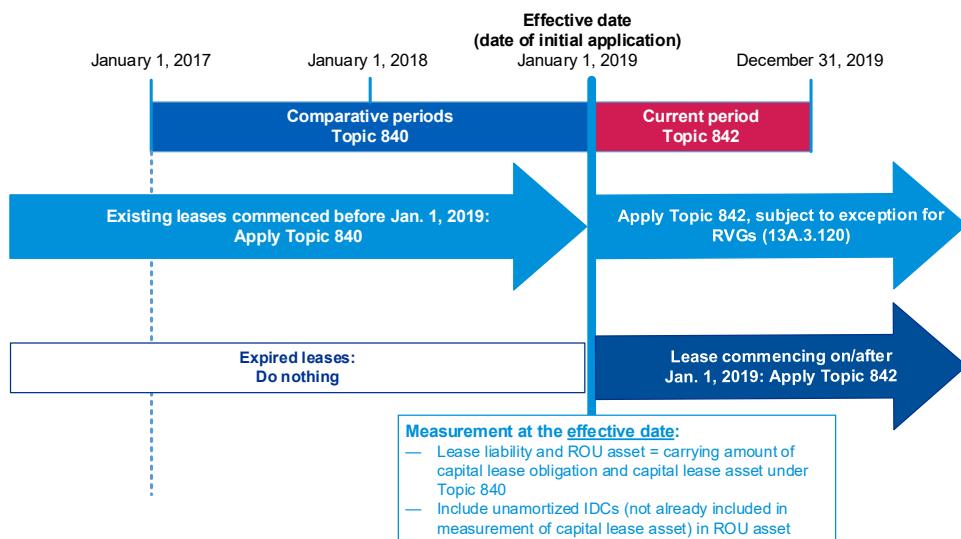
Year ended	Operating lease cost
Dec. 31, 2020	\$28,150
Dec. 31, 2021	28,150
Dec. 31, 2022	28,150

Note:

1. A lessee continues to present lease cost in a manner consistent with its presentation under Topic 840 (e.g. SG&A expenses).

## Capital leases under Topic 840

13A.3.90 The following diagram gives an overview of the transition requirements for a capital lease, which is explained in this section, assuming a public business entity with a calendar year-end.



### Initial recognition and measurement

13A.3.100 The lease liability and ROU asset are initially measured as follows at the effective date (subject to the considerations in Question 13A.2.50). [842-10-65-1(r)(1) – 65-1(r)(2)]

Topic 842 item	Measurement
Lease liability	<ul style="list-style-type: none"> <li>Carrying amount of capital lease obligation under Topic 840 immediately before the effective date.</li> </ul>
ROU asset	<ul style="list-style-type: none"> <li>Carrying amount of the capital lease asset under Topic 840 immediately before the effective date.</li> <li>Plus any unamortized initial direct costs not included in the capital lease asset under Topic 840.</li> </ul>

### Subsequent measurement beginning on the effective date

13A.3.110 A lessee measures the ROU asset and the lease liability in accordance with the subsequent measurement guidance applicable to new finance leases under Topic 842.

13A.3.120 As an exception, a lessee does not remeasure the lease payments for changes in amounts probable of being owed under residual value guarantees unless the lease liability is remeasured for other reasons – e.g. because of a change in the lease term or in the assessment of a lessee purchase option. [842-10-65-1(r)(5)]

### Presentation and disclosure

13A.3.130 A lessee presents the assets and liabilities under capital leases as ROU assets and lease liabilities arising from finance leases for presentation and disclosure purposes in all periods following the effective date. [842-10-65-1(r)(6)]



### Example 13A.3.30

#### **Lessee transition for an existing capital lease with package of practical expedients elected**

##### **Scenario 1: Lease is not modified or remeasured on or after the effective date**

###### **About the lease**

The following summarizes relevant information about Lessee LE's lease of equipment.

Commencement date of the lease:	January 1, 2016
Lease term:	7 years
Lease payments (annual, paid in arrears):	\$40,000
Residual value guarantee (lessee):	\$6,000
Amount probable of being owed under the residual value guarantee (no change throughout lease term):	\$2,000
Lease classification at inception under Topic 840:	Capital lease
LE's incremental borrowing rate at lease inception:	5.5%
Initial direct costs, amortized on a straight-line basis over the lease term:	\$2,500

LE elects the package of practical expedients. Therefore, LE does not reassess whether the contract is or contains a lease, whether classification of the lease would be different under Topic 842, or whether the unamortized initial direct costs at January 1, 2019 would meet the definition of initial direct costs under Topic 842.

###### **Worksheet at January 1, 2019 (the effective date)**

Step	Amounts debit/(credit)	Notes
Recognize lease liability	\$(145,048)	Equal to existing capital lease obligation
Recognize ROU asset	135,396	Equal to existing capital lease asset (\$133,967) + existing unamortized IDCs (\$1,429)
<b>Adjustment to equity</b>	<b>\$</b>	- N/A – replacing existing assets and liabilities at the same amounts

###### **Subsequent accounting for the lease**

LE will account for the lease liability and ROU asset in accordance with the subsequent measurement guidance in Topic 842 from January 1, 2019 through the end of the lease term. However, as an exception, because the entire amount of the \$6,000 residual value guarantee is already included in the lease liability, LE will not make any adjustments for changes in the amount that it is probable of owing under the residual value guarantee.

LE does not modify the lease or have to remeasure the lease liability (e.g. for a change in the lease term) subsequent to the effective date. The following tables show the effect of the lease accounting on the financial statements.

#### *Balance sheet*

LE recognizes the following amounts in its balance sheet through the end of the lease term.

Year ended	ROU asset arising from finance lease	Lease liability arising from finance lease
Dec. 31, 2019 <sup>1</sup>	\$102,547	\$113,026
Dec. 31, 2020	69,698	79,242
Dec. 31, 2021	36,849	43,601
Dec. 31, 2022	4,000	6,000

Note:

- Because LE elected the effective date method, no ROU asset or lease liability is presented in the comparative December 31, 2018 balance sheet. Instead, the amounts will be presented as capital lease assets and capital lease obligations under Topic 840. We expect that many lessees will present their finance lease ROU assets and finance lease liabilities in the same balance sheet line item as they presented capital lease assets and capital lease obligations under Topic 840.

At the end of the lease term, LE makes a payment under the residual value guarantee and credits cash for \$2,000, debits the lease liability for \$6,000 and credits the ROU asset for \$4,000.

#### *Income statement<sup>1</sup>*

LE recognizes the following amounts in its income statement through the end of the lease term.

Year ended	Interest expense	Amortization of ROU asset
Dec. 31, 2019	\$7,978	\$32,849
Dec. 31, 2020	6,216	32,849
Dec. 31, 2021	4,359	32,849
Dec. 31, 2022	2,399	32,849

Note:

- The interest expense on the lease liability and amortization of the ROU asset are not required to be presented as separate line items; rather each is presented in a manner consistent with how the entity presents other interest expense and depreciation or amortization of similar assets (see section 6.9).

#### **Scenario 2: Lease liability is remeasured after the effective date**

Changing the facts of Scenario 1, on January 1, 2020, LE remeasures the lease liability. The lease included a renewal option and LE now determines that it is reasonably certain to exercise the option based on the occurrence of a significant event that is within its control (see section 6.6).

As a result, LE applies the lease accounting guidance under Topic 842 beginning on the remeasurement date (January 1, 2020). The following summarizes relevant information for the remeasurement of the lease liability.

Renewal period:	3 years
Remaining lease term:	6 years
Lease payments for the renewal period (annual, paid in arrears):	\$43,000
Lease payments for the remainder of the original lease term (annual, paid in arrears):	\$40,000
Amount probable of being owed under the residual value guarantee at the end of the revised lease term:	\$1,500
LE's incremental borrowing rate at January 1, 2020:	6.0%

### **Lease liability remeasurement**

In this example, LE identifies one difference between Topic 840 and Topic 842 that affects the measurement of the lease liability and the ROU asset. Under Topic 840, minimum lease payments included the full amount of a lessee residual value guarantee (and therefore the capital lease obligation and the capital lease asset reflect the full amount of such guarantee) while the definition of lease payments under Topic 842 includes only amounts probable of being owed by the lessee to satisfy the guarantee.

LE remeasures the lease liability based on:

- three remaining payments of \$40,000 (the remainder of the original lease term);
- three additional payments of \$43,000 to reflect the renewal period; and
- a final payment of \$1,500 to satisfy the residual value guarantee.

LE discounts the stream of lease payments at its incremental borrowing rate of 6.0% at January 1, 2020. This results in a remeasured lease liability of \$204,483, or an increase of \$91,457 compared to the lease liability balance immediately before the remeasurement date.

### **Journal entry**

LE records the following journal entry at January 1, 2020.

	<i>Debit</i>	<i>Credit</i>
ROU asset	91,457	
Lease liability		91,457
<i>To remeasure ROU asset and lease liability following reassessment of lease term.</i>		

### **Lease classification**

LE also reassesses lease classification, concurrent with the remeasurement of the lease, based on the facts and circumstances at the remeasurement date (e.g. the fair value and remaining economic life of the underlying asset at that date) and determines that the lease is still a finance lease.

### **Subsequent accounting for the lease**

LE prospectively accounts for the lease liability and the ROU asset using the guidance in Topic 842 for a finance lease (see section 6.4.1).

- The lease liability carrying amount is increased each period of the remaining lease term to reflect interest on the lease liability, and reduced to reflect the lease payments made during the period.
- The ROU asset is measured at cost less any accumulated amortization (and any accumulated impairment losses).

#### *Balance sheet*

LE recognizes the following amounts in its balance sheet for its lease of equipment through the end of the revised lease term.

<b>Year ended</b>	<b>ROU asset arising from finance lease</b>	<b>Lease liability arising from finance lease</b>
Dec. 31, 2020	\$161,670	\$176,752
Dec. 31, 2021	129,336	147,357
Dec. 31, 2022	97,002	116,198
Dec. 31, 2023	64,668	80,170
Dec. 31, 2024	32,334	41,980
Dec. 31, 2025	-	1,500

At the end of the lease term, LE makes a payment under the residual value guarantee, debits the lease liability for \$1,500 and credits cash for \$1,500.

#### *Income statement<sup>1</sup>*

LE recognizes the following amounts in its income statement for its lease of equipment through the end of the revised lease term.

<b>Year ended</b>	<b>Interest expense</b>	<b>Amortization of ROU asset</b>
Dec. 31, 2020	\$12,269	\$32,334
Dec. 31, 2021	10,605	32,334
Dec. 31, 2022	8,841	32,334
Dec. 31, 2023	6,972	32,334
Dec. 31, 2024	4,810	32,334
Dec. 31, 2025	2,520	32,334

Note:

1. The interest expense on the lease liability and amortization of the ROU asset are not required to be presented as separate line items in the income statement; rather each is presented in a manner consistent with how the entity presents other interest expense and depreciation or amortization of similar assets (see section 6.9).

### 13A.3.2 Lessee does not elect package of practical expedients

13A.3.140 Section 13A.3.1 discussed the lessee transition requirements when the lessee elects the package of practical expedients and includes Questions 13A.3.10 – 13A.3.130. Despite the inclusion of those questions in section 13A.3.1, we believe the responses to those questions do not change if the lessee does not elect the package of practical expedients or the use of hindsight practical expedient.

#### **Leases previously classified as operating leases under Topic 840**

##### **Leases classified as operating leases under Topic 842**

13A.3.150 In general, the recognition, initial measurement and subsequent measurement of the lease liability and ROU asset are the same as for a lessee that elects the package of practical expedients for its leases (see paragraphs 13A.3.30 – 13A.3.80). As an exception, at the effective date, a lessee writes off as an adjustment to equity any unamortized initial direct costs that do not meet the definition of initial direct costs under Topic 842. This means that the initial and subsequent measurement of the lessee's ROU asset, and periodic lease cost after the effective date, will differ between a lessee that elects the package of practical expedients and one that does not for the same lease for the effect of initial direct costs written off at the effective date.  
[842-10-65-1(k), 65-1(n), 65-1(p)]

##### **Leases classified as finance leases under Topic 842**

###### **Initial recognition and measurement**

13A.3.160 The lease liability is recognized and measured the same as for an existing operating lease that remains classified as an operating lease (see paragraph 13A.3.150). [842-10-65-1(o)]

13A.3.170 The ROU asset is recognized and measured using the formula in paragraph 13A.3.50, except that the starting point is a *proportion of the original lease liability* – i.e. the lease liability as of the original commencement date that is calculated as follows.



Note:

1. Topic 842 states that this amount can be 'imputed' from the remaining lease liability, rather than directly calculated. Example 13A.3.40 demonstrates imputing the original lease liability and this is further discussed as part of the Example. [842-10-65-1(o)]

###### **Subsequent measurement**

13A.3.180 Subsequent to initial recognition and measurement, there is no difference in accounting for the finance lease solely because it was previously

classified as an operating lease under Topic 840 – i.e. compared with a finance lease previously classified as a capital lease under Topic 840. Example 13A.3.40 illustrates the accounting for an existing lease classified as an operating lease under Topic 840 but classified as a finance lease under Topic 842.

### **Leases previously classified as capital leases under Topic 840**

#### **Leases classified as finance leases under Topic 842**

13A.3.190 In general, the recognition, initial measurement and subsequent measurement of the lease liability and ROU asset are the same as for a lessee that elects the package of practical expedients for its leases. However, as an exception, at the effective date, a lessee writes off as an adjustment to equity any unamortized initial direct costs that do not meet the definition of initial direct costs under Topic 842 and that are not included in the measurement of the capital lease asset under Topic 840. This means that the initial and subsequent measurement of the lessee's ROU assets, and amortization thereon, will differ between a lessee that elects the package of practical expedients and one that does not for the same lease for the effect of initial direct costs written off at the effective date. [842-10-65-1(r), 65-1(t)]

#### **Leases classified as operating leases under Topic 842**

##### **Transition adjustments**

13A.3.200 At the effective date, a lessee: [842-10-65-1(s)]

- derecognizes the carrying amount of the capital lease asset and capital lease obligation determined under Topic 840; the difference is accounted for as prepaid or accrued rent; and
- writes off as an adjustment to equity any unamortized initial direct costs that do not meet the definition of initial direct costs under Topic 842.

##### **Initial recognition and measurement**

13A.3.210 The lessee initially measures the operating lease liability and operating lease ROU asset as of the effective date using the *subsequent* measurement guidance in Subtopic 842-20. [842-10-65-1(s)(2)]

##### **Subsequent recognition and measurement**

13A.3.220 Subsequent to the effective date, the lessee accounts for the operating lease in the same manner as it accounts for any other operating lease under Topic 842. [842-10-65-1(s)(4)]



#### Observation

#### **Changes in lessee lease classification in transition**

13A.3.230 In general, we believe it will be relatively infrequent that a lease classified as an operating lease under Topic 840 will be classified as a finance lease under Topic 842 or vice versa. However, here are a few examples of changes in the lease classification guidance that could result in different outcomes.

- Four of the five classification tests in Topic 842 for determining if a lease is a finance lease are substantially similar to those in Topic 840 for determining if a lease is a capital lease. However, Topic 842 includes a fifth test (the 'alternative use' test – see section 6.2) that has no equivalent in Topic 840. The introduction of this test could result in some Topic 840 operating leases being classified as finance leases if reassessed under Topic 842.
- Lessees under Topic 840 do not consider either the lease term or present value classification tests (see section 6.2) when the lease term falls within the last 25 percent of the total estimated economic life of the underlying asset. Topic 842 only includes a similar exemption for the lease term test (see section 6.2). Consequently, some leases for which the present value test in Topic 840 was not even considered would have to consider the similar present value test in Topic 842 and some of those leases might therefore be classified as finance leases.
- While Topic 842 permits entities to continue to use 75 and 90 percent as bright-line thresholds when performing the lease term and present value lease classification tests, respectively, it does not require use of those thresholds. Consequently, an entity not using those thresholds could reach a different conclusion about the classification of some of its existing leases if it reassesses lease classification under Topic 842 (see section 6.2).

13A.3.240 In the first two examples mentioned above, the result of the changes to the lease classification guidance from Topic 840 to Topic 842 is that a previously classified operating lease might be classified as a finance lease. In the third example, in theory, the effect could be that a previously classified operating lease is classified as a finance lease or vice versa; however, it appears less likely that an entity could reasonably conclude that a lease term greater than 75 percent is not a 'major part' of the remaining economic life of the underlying asset or a present value of lease payments greater than 90 percent of the fair value of the underlying asset is not 'substantially all' of the fair value of the underlying asset than the opposite. For further discussion, see Questions 6.2.10 and 6.2.20.

13A.3.250 Based on our evaluation of the guidance, we believe, to the extent some changes in lease classification would occur if a lessee were not to elect the package of practical expedients, most of those differences will be in the direction of previously classified operating leases becoming finance leases, rather than vice versa.



#### Example 13A.3.40

#### **Lessee transition for operating lease under Topic 840 classified as a finance lease under Topic 842 – package of practical expedients not elected**

The following summarizes relevant information about Lessee LE's lease of a machine.

Commencement date of the lease:	January 1, 2015
Lease term:	6 years
Minimum rental payments determined under Topic 840 (annual, paid in arrears):	\$51,000 first 3 years \$55,000 last 3 years
Lease classification at inception under Topic 840:	Operating lease
Initial direct costs:	None

LE does not elect the package of practical expedients available under Topic 842.

### At January 1, 2019 (the effective date)

Assume that the lease would have been classified as a finance lease under Topic 842 at lease commencement. At January 1, 2019, LE's incremental borrowing rate is 6% (see section 5.6 and Question 13A.3.50).

#### Lease liability measurement

On January 1, 2019, LE measures the finance lease liability as \$100,837, which is the present value of two payments of \$55,000, discounted at 6%.

#### ROU asset measurement

LE determines the carrying amount of the ROU asset at January 1, 2019 using the formula described in Topic 842 as follows.

<b>Step 1:</b>	Determine the minimum rental payments over the remaining lease term as of the effective date: $(\$55,000 \times 2) = \$110,000$
<b>Step 2:</b>	Determine the lease term at lease commencement: 6 years Assume LE does not elect the use-of-hindsight transition practical expedient (see section 13A.2). Therefore, at the effective date, LE does not revisit its previous conclusion about the lease term. If LE had elected to use hindsight, the total and remaining lease term would reflect LE's re-evaluation as of the effective date (see Question 13A.2.40).
<b>Step 3:</b>	Determine the remaining lease term as of the effective date: 2 years
<b>Step 4:</b>	Divide the amount determined in Step 1 by the amount determined in Step 3: $\$110,000 / 2 \text{ years} = \$55,000 \text{ per year}$
<b>Step 5:</b>	Determine the present value of the periodic payment calculated in Step 4 over the lease term identified in Step 2 using the lessee's incremental borrowing rate at the effective date: \$55,000 per year in arrears for 6 years discounted at 6% = \$270,453
<b>Step 6:</b>	Multiply the amount in Step 5 by the ratio of the remaining lease term calculated in Step 3 divided by the lease term identified in Step 2: $\$270,453 \times (2 / 6) = \$90,151$
<b>Step 7:</b>	Add to the amount calculated in Step 6 the amount of any previously recognized prepaid rental payments (and subtract from that amount any accrued rental payments): $\$90,151 - \$4,000 = \$86,151$

#### Journal entry

The difference between the ROU asset and the lease liability on January 1, 2019, is an adjustment to opening retained earnings at that date. Lessee LE

recognizes the following journal entry to reflect the transition of the operating lease to a finance lease.

	<i>Debit</i>	<i>Credit</i>
ROU asset	86,151	
Accrued rent	4,000	
Retained earnings	10,686	
Lease liability		100,837
<i>To recognize finance lease on transition.</i>		

### Subsequent accounting for the lease

Subsequent to January 1, 2019, LE's accounting is no different from that illustrated in Example 13A.3.30, Scenario 1.

#### ***Imputing the commencement date lease liability – alternative approach***

In specifying measurement of the ROU asset as a proportion of the original lease liability (the lease liability at the commencement date), Topic 842 allows the original lease liability to be imputed from the lease liability determined at the effective date. There is no additional guidance or an example of how to do this.  
[\[842-10-65-1\(o\)\]](#)

The 2013 Exposure Draft included an illustrative example of how to impute the original lease liability from the effective date lease liability. The approach illustrated above imputes the original lease liability in the same manner as in the 2013 Exposure Draft. However, because the example was not carried forward to Topic 842, there may be other ways an entity could meet the requirements. In addition, in the Exposure Draft, the lease liability was not calculated based on the remaining minimum rental payments as is now required by paragraph 842-10-65-1(l).

For example, the guidance would not appear to prohibit the lessee in this example from calculating the 'original lease liability' based on the actual minimum rental payments (\$51,000 for the first three years; \$55,000 for the final three years), rather than the derived lease payments of \$55,000 illustrated. In that case:

- The original lease liability, using the 6% discount rate for the lease, would be \$259,761 (rather than \$270,453).
- The lessee would then multiply that amount (\$259,761) by the ratio of the remaining lease term calculated in Step 3 divided by the lease term identified in Step 2 ( $\$259,751 \times (2 / 6) = \$86,587$ ).
- As with the other approach, the lessee would reduce this amount (\$86,587) by the amount of the accrued rent ( $\$86,587 - \$4,000 = \$82,587$ ).

Under this approach, at January 1, 2019 LE would record a slightly different journal entry than that recorded using the preceding approach.

	Debit	Credit
ROU asset	82,587	
Accrued rent	4,000	
Retained earnings	14,250	
Lease liability		100,837
<i>To recognize finance lease on transition.</i>		

### 13A.3.3 ASU 2021-09, Discount Rate for Lessees That Are Not Public Business Entities

13A.3.260 ASU 2021-09 (issued November 11, 2021) permits a lessee that is not a public business entity to use a risk-free discount rate for the lease, instead of its incremental borrowing rate, as an accounting policy election by class of underlying asset. The ASU also clarifies that a lessee must use the rate implicit in the lease when it is readily determinable even if it has elected the risk-free discount rate expedient. [842-20-30-3]

13A.3.270 The effective dates of the amendments in ASU 2021-09 are as follows. [842-10-65-6]

<b>Effective date</b>	<b>Entities that adopted Topic 842 before ASU 2021-09 was issued</b>	<b>Entities that did not adopt Topic 842 before final ASU was issued</b>
Annual periods – fiscal years beginning after	December 15, 2021	Adopt when the entity adopts Topic 842
Interim periods – in fiscal years beginning after	December 15, 2022	
Early adoption allowed?	Yes, as of the beginning of fiscal year	

13A.3.280 The available transition approaches depend on the entity's Topic 842 adoption status as of November 11, 2021 (i.e. the issuance date of ASU 2021-09).

- **Private entities that have not yet adopted Topic 842** will adopt the amendments in ASU 2021-09 at the same time and using the same transition method they use to adopt Topic 842 – either the effective date method or the comparative method (see chapters 13A and 13B, respectively).
- **Private entities that have already adopted Topic 842** will apply ASU 2021-09 on a modified retrospective basis to all leases that exist at the adoption date of the ASU's amendments through a cumulative effect adjustment to retained earnings at the beginning of their fiscal year.

### 13A.3.4 ASU 2023-01, Common Control Arrangements

13A.3.290 ASU 2023-01 (issued March 27, 2023) contains amendments to Topic 842 around two issues that apply to arrangements between entities under common control.

13A.3.300 The effective dates of the amendments in ASU 2023-01 are as follows. An entity can select different adoption dates and transition methods for Issue 1 and Issue 2. For example, an entity can (1) early adopt only Issue 1 or Issue 2 and (2) elect a prospective transition method for one issue and a retrospective transition method for the other. [842-10-65-7, 65-8]

Effective date	Issue 1 (private entities only)	Issue 2 (all entities)
Annual periods – fiscal years beginning after	December 15, 2023	December 15, 2023
Interim periods – in fiscal years beginning after	December 15, 2023	December 15, 2023
Early adoption allowed?	Yes, in any annual or interim period, as of the beginning of the fiscal year, for which financial statements have not yet been made available for issuance	
Entities that have not issued (or made available for issuance) financial statements under Topic 842 before final ASU was issued		May adopt concurrent with Topic 842

#### Issue 1

13A.3.310 ASU 2023-01 permits a private entity to elect a practical expedient to use the written terms and conditions, as opposed to the legally enforceable terms and conditions, of a common control leasing arrangement to determine whether a lease exists and, if so, to determine the classification of and accounting for that lease. See section 3.1.2. [842-10-15-3A]

13A.3.320 The available transition approaches depend on the entity's Topic 842 adoption status as of March 27, 2023 (i.e. the issuance date of ASU 2023-01). [842-10-65-7]

- **Private entities that have not yet issued (or made available for issuance) financial statements under Topic 842** have the option to adopt the Issue 1 amendments in their first Topic 842 compliant financial statements and use the same transition method as they use to adopt the remainder of Topic 842 (i.e. the effective date method – for the comparative method, see chapter 13B).
- **Private entities that have already applied Topic 842 in financial statements that have been issued (or made available for issuance)** have the option to adopt the Issue 1 amendments:
  - prospectively to common control arrangements that commence or are modified on or after the entity's adoption date of the Issue 1

amendments (e.g. January 1, 2024 if a calendar year entity that does not early adopt the amendments); or

- on a modified retrospective basis to all common control arrangements that still exist at the entity's adoption date of the Issue 1 amendments.

Under the modified retrospective transition approach, the entity records the effect of adopting the Issue 1 amendments through a cumulative-effect adjustment to retained earnings at the beginning of the earliest period presented in the financial statements.

For example, assume that a calendar year private entity adopted Topic 842 on January 1, 2022; adopted the Issue 1 amendments on January 1, 2024; and is issuing financial statements that will present 2023 and 2024. Under this transition approach, the entity would record the required cumulative-effect adjustment as of January 1, 2023 (beginning of earliest period presented), but based on an assumed retrospective application as of January 1, 2022 (Topic 842 adoption date) to common control arrangements still in place at January 1, 2024.

## **Issue 2**

13A.3.330 The Issue 2 amendments require that a lessee in a common control lease that is the accounting owner of related leasehold improvements generally amortize the improvements over their estimated useful life to the common control group, regardless of the Topic 842 lease term, as long as it continues to control the use of the underlying asset (see section 6.4). [\[842-20-35-12A\]](#)

13A.3.340 The available transition approaches depend on the entity's Topic 842 adoption status as of March 27, 2023 (i.e. the issuance date of ASU 2023-01). [\[842-10-65-8\]](#)

- **Entities that have not yet issued (or made available for issuance) financial statements under Topic 842** have the option to adopt the Issue 2 amendments in their first Topic 842 compliant financial statements and use the same transition method as they used to adopt the remainder of Topic 842 (i.e. the effective date method – for the comparative method, see chapter 13B). Alternatively, these entities may use one of the two prospective methods outlined below for entities that have already adopted Topic 842.

- **Entities that have already applied Topic 842 in financial statements that have been issued (or made available for issuance)** have the following three options to adopt the Issue 2 amendments.

- Prospectively to all leasehold improvements that are recognized on or after the date the entity first applies the amendments (e.g. January 1, 2024 for a calendar year entity that does not early adopt).
- Prospectively to all new and existing leasehold improvements that are recognized on or after the date the entity first applies the amendments, with the remaining unamortized balance of existing leasehold improvements amortized over their remaining useful life to the common control group (determined as of that same date).
- On a modified retrospective basis (i.e. to the beginning of the period in which Topic 842 is first applied – *e.g. January 1, 2022 for a calendar*

*year private entity that did not early adopt Topic 842) by applying the amendments to existing leasehold improvements at the Issue 2 adoption date (e.g. January 1, 2024 for a calendar year entity that does not early adopt those amendments), with a cumulative-effect adjustment to the opening balance of retained earnings at the beginning of the earliest period presented (e.g. January 1, 2023 if the entity is presenting 2023 and 2024 in its financial statements) for any leasehold improvements recognized as a result of adopting the ASU.*

## 13A.4 Transition for lessors



### Excerpt from ASC 842-10

#### 65 Transition and Open Effective Date Information

##### General

> Transition Related to Accounting Standards Updates No. 2016-02, *Leases (Topic 842)*, No. 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*, No. 2018-10, *Codification Improvements to Topic 842, Leases*, No. 2018-11, *Leases (Topic 842): Targeted Improvements*, No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, 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*, No. 2020-05, *Revenue from Contracts with Customers (Topic 606)* and *Leases (Topic 842): Effective Dates for Certain Entities*, No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*, No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*, and No. 2023-01, *Leases (Topic 842): Common Control Arrangements*

**65-1** The following represents the transition and effective date information related to Accounting Standards Updates No. 2016-02, *Leases (Topic 842)*, No. 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*, No. 2018-10, *Codification Improvements to Topic 842, Leases*, No. 2018-11, *Leases (Topic 842): Targeted Improvements*, No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, 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*, No. 2020-05, *Revenue from Contracts with Customers (Topic 606)* and *Leases (Topic 842): Effective Dates for Certain Entities*, No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*, No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*, and No. 2023-01, *Leases (Topic 842): Common Control Arrangements*: [Note: See paragraph 842-10-S65-1 for an SEC Staff Announcement on transition related to Update 2016-02.]

## Lessors

### Leases previously classified as operating leases under Topic 840

- 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.
- 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:
  - 1. Derecognize the carrying amount of the underlying asset at the application date as determined in (c).
  - 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.
  - 3. Record any difference between the amounts in (w)(1) and (w)(2) as follows:
    - 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).
    - ii. If an entity elects the transition method in (c)(2), as an adjustment to equity.
  - 4. Account for the lease in accordance with this Topic after the application date as determined in (c).

### Leases previously classified as direct financing or sales-type leases under Topic 840

- 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).
- y. For each lease classified as an operating lease in accordance with this Topic, the objective is to account for the lease, beginning on the application date as determined in (c), as if it had always been accounted for as an operating lease in accordance with this Topic. Consequently, a lessor shall do all of the following:
1. Recognize the underlying asset at what the carrying amount would have been had the lease been classified as an operating lease under Topic 840.
  2. Derecognize the carrying amount of the net investment in the lease.
  3. Record any difference between the amounts in (y)(1) and (y)(2) as follows:
    - 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) or earnings (if the commencement date of the lease was on or after the beginning of the earliest period presented).
    - ii. If an entity elects the transition method in (c)(2), as an adjustment to equity.
  4. Subsequently account for the operating lease in accordance with this Topic and the underlying asset in accordance with other Topics.

> Transition Related to Accounting Standards Update No. 2018-11, *Leases (Topic 842): Targeted Improvements*

**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.
- > Transition Related to Accounting Standards Update No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*
- 65-3** 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*:
- 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 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 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:
    - 1. In the first reporting period ending after the issuance of the pending content that links to this paragraph
    - 2. In the first reporting period beginning after the issuance of the pending content that links to this paragraph.
  - 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:
    - 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.

> Transition 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*

**65-4** 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. Early 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).

> Transition Related to Accounting Standards Update No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*

**65-5** The following represents the transition and effective date information related to Accounting Standards Update No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*:

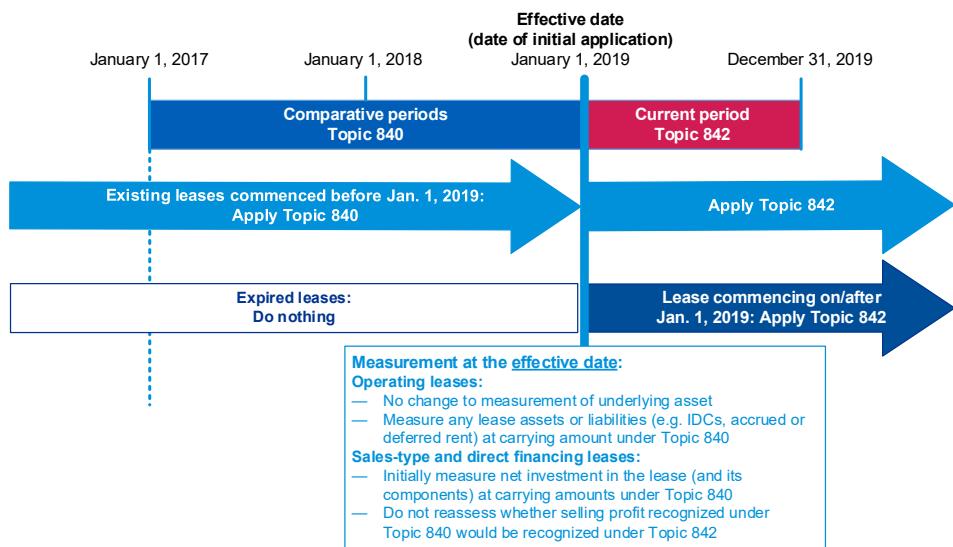
- a. An entity that has not yet adopted the pending content that links to paragraph 842-10-65-1 as of July 19, 2021, shall apply the pending content that links to this paragraph when it first applies the pending content that links to paragraph 842-10-65-1 and shall apply the same transition method elected for the pending content that links to paragraph 842-10-65-1.
- b. An entity within the scope of paragraph 842-10-65-1(a) that has adopted the pending content that links to paragraph 842-10-65-1 as of July 19, 2021, shall apply the pending content that links to this paragraph for fiscal years beginning after December 15, 2021, and interim periods within those fiscal years. Earlier application is permitted.

- c. An entity within the scope of paragraph 842-10-65-1(b) that has adopted the pending content that links to paragraph 842-10-65-1 as of July 19, 2021, shall apply the pending content that links to this paragraph for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. Earlier application is permitted.
- d. An entity within the scope of (b) or (c) shall apply the pending content that links to this paragraph by using one of the following two methods:
  - 1. Retrospectively to the date in which the pending content that links to paragraph 842-10-65-1 was adopted (the beginning of the period of adoption of Topic 842). Under this transition method, the entity shall apply the pending content that links to this paragraph to leases that commence or are modified on or after the beginning of the period of its adoption of Topic 842 and do not meet the conditions in paragraph 842-10-25-8.
  - 2. Prospectively to leases that commence or are modified on or after the date that the entity first applies the pending content that links to this paragraph and do not meet the conditions in paragraphs 842-10-25-8.
- e. An entity within the scope of (b) or (c) that elects the transition method in (d)(1) shall provide the following transition disclosures:
  - 1. The applicable 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
  - 2. The transition disclosures in paragraph 250-10-50-1(b)(3) as of the beginning of the earliest period presented but not before the date in which the pending content that links to paragraph 842-10-65-1 was adopted.
- f. An entity within the scope of (b) or (c) that elects the transition method in (d)(2) shall provide the following transition disclosures:
  - 1. The nature of and reason for the change in accounting principle
  - 2. The transition method
  - 3. A qualitative description of the financial statement line items affected by the change.

### **13A.4.1 Lessor elects package of practical expedients**

13A.4.10 The following are the transition requirements applicable to a lessor that elects the package of practical expedients. Because lease classification is not reassessed in applying the package of practical expedients: [842-10-65-1(f)(2)]

- all existing leases classified as operating leases under Topic 840 will be classified as operating leases under Topic 842; and
- all existing leases classified as sales-type or direct financing leases under Topic 840 will be classified as sales-type or direct financing leases under Topic 842.



### ***Leases previously classified as operating leases under Topic 840***

13A.4.20 At the effective date, a lessor: [842-10-65-1(v)]

- continues to recognize the underlying asset and any lease assets or liabilities (e.g. accrued or deferred rent income) at their carrying amounts recognized in accordance with Topic 840 immediately before the effective date; and
- accounts for previously recognized securitized receivables as secured borrowings in accordance with other GAAP, if applicable.

13A.4.30 After the effective date, the lessor accounts for the operating lease in accordance with the operating lease guidance in Topic 842.

### ***Leases previously classified as sales-type or direct financing leases under Topic 840***

13A.4.40 At the effective date, the lessor continues to recognize a net investment in the lease equal to the carrying amount of the net investment immediately preceding that date; this includes any unamortized initial direct costs capitalized as part of the net investment in the lease in accordance with Topic 840. An exception arises if election of the hindsight practical expedient results in a change to the lease term or the assessment of a lessee purchase option (see Question 13A.2.50). [842-10-65-1(x)(1) – 65-1(x)(2)]

13A.4.50 After the effective date, the lessor accounts for the net investment in the lease under the Topic 842 recognition, subsequent measurement, presentation and disclosure guidance. [842-10-65-1(x)(3)]

13A.4.60 If the lease is modified (and that modification is not accounted for as a separate contract) on or after the effective date, a lessor applies Topic 842 beginning at the modification date and accounts for the modification under the lessor modifications guidance in Topic 842. A lessor does not remeasure the net investment in the lease after the effective date unless the lease is modified

(and that modification is not accounted for as a separate contract).  
[\[842-10-65-1\(x\)\(4\)\]](#)

## 13A.4.2 Lessor does not elect package of practical expedients

### ***Leases previously classified as operating leases under Topic 840***

#### **Leases classified as operating leases under Topic 842**

13A.4.70 The accounting at and subsequent to the effective date is the same as it is for a lessor that elects the package of practical expedients for its leases. As an exception, at the effective date, any unamortized initial direct costs that do not meet the definition of initial direct costs under Topic 842 are written off as an adjustment to equity. [\[842-10-65-1\(v\)\(3\)\]](#)

#### **Leases classified as direct financing or sales-type leases under Topic 842**

13A.4.80 The objective is to account for the lease, beginning on the effective date, as if it had always been accounted for as a direct financing lease or a sales-type lease in accordance with Topic 842. Therefore, at the effective date a lessor: [\[842-10-65-1\(w\)\]](#)

- derecognizes the carrying amount of the underlying asset;
- recognizes a net investment in the lease as if the lease had been accounted for as a direct financing lease or a sales-type lease under Topic 842 since lease commencement; and
- records the difference between the carrying amount of the underlying asset derecognized and the net investment in the lease recognized as an adjustment to equity.

13A.4.90 After the effective date, the lessor accounts for the lease in accordance with Topic 842. [\[842-10-65-1\(w\)\(4\)\]](#)

### ***Leases previously classified as direct financing or sales-type leases under Topic 840***

#### **Leases classified as direct financing or sales-type leases under Topic 842**

13A.4.100 The accounting at, and subsequent to, the effective date is the same as it is for a lessor that elects the package of practical expedients for its leases (see section 13A.4.1). [\[842-10-65-1\(x\)\]](#)

13A.4.110 Initial direct costs included in the measurement of the net investment in the lease are not written off even if they do not meet the definition of initial direct costs under Topic 842. [\[842-10-65-1\(x\)\(1\)\]](#)

#### **Leases classified as operating leases under Topic 842**

13A.4.120 The objective is to account for the lease, beginning at the effective date, as if it had always been accounted for as an operating lease in accordance with Topic 842. Therefore, at the effective date, a lessor: [\[842-10-65-1\(y\)\(1\) – 65-1\(y\)\(3\)\]](#)

- derecognizes the carrying amount of the net investment in the lease;
- recognizes the underlying asset at the carrying amount that would have been recognized had the lease been classified as an operating lease under Topic 840; and
- records any difference between the carrying amount of the underlying asset recognized and the net investment in the lease derecognized as an adjustment to equity.

13A.4.130 A lessor subsequently accounts for the operating lease in accordance with Topic 842 and the underlying asset in accordance with other GAAP.  
[842-10-65-1(y)(4)]



#### Question 13A.4.10

##### **Offset to assets and liabilities written off on transition**

**If the classification of a lease changes on transition, is the difference between those assets and liabilities derecognized and those recognized by the lessor taken as an adjustment to equity if the lease commenced during one of the comparative periods presented in the financial statements?**

**Interpretive response:** Yes. This is because, under the effective date method, the comparative periods presented in the lessor's interim and annual adoption-year financial statements are not revised from what was previously issued. Therefore, any adjustments resulting from changes in lease classification necessarily flow through equity at the effective date. [842-10-65-1(c)(2), ASU 2018-11-BC7]



#### Example 13A.4.10

##### **Lessor transition for an operating lease under Topic 840 classified as a sales-type lease under Topic 842**

The following summarizes relevant information about Lessor LR's lease of equipment. In this example, LR does not elect the package of practical expedients.

Commencement date of the lease:	January 1, 2016
Lease term:	5 years
Renewal, termination or purchase options:	None
Lease payments (annual, paid in arrears):	\$17,000
Estimated residual value of the equipment at the end of the lease term:	\$18,000
Residual value guarantee (provided by either lessee or third party):	None
Fair value at January 1, 2016:	\$77,000

Carrying amount at January 1, 2016:	\$77,000
Remaining (and original) economic life of the equipment:	7 years
Useful life of the equipment:	7 years
Initial direct costs incurred by lessor under Topic 840 (only \$800 would meet the definition of initial direct costs under Topic 842):	\$2,000
Rate implicit in the lease under Topic 840, which does not factor in initial direct costs:	9.368%
Rate implicit in the lease under Topic 842 (see section 5.6):	9.01%
Lease classification at inception under Topic 840:	Operating lease

The lease is not modified on or after the effective date.

LR does not elect the package of practical expedients. Therefore, it reassesses whether the arrangement is or contains a lease, whether classification of the lease would be different under Topic 842, and whether the unamortized initial direct costs of \$800 at January 1, 2019 would have qualified for capitalization under Topic 842.

LR determines that the arrangement is still a lease. However, the lease is classified as a sales-type lease under Topic 842. Only \$800 of the \$2,000 in initial direct costs under Topic 840 meet the definition of initial direct costs under Topic 842, but that \$800 would also have been capitalized because the fair value of the underlying asset equaled its carrying amount at lease commencement.

#### Worksheet at January 1, 2019 (the effective date)

The objective of the transition guidance in this case is to account for the lease, beginning on January 1, 2019 (i.e. the effective date), as if it had always been a sales-type lease accounted for in accordance with Topic 842.

Step	Amounts debit/(credit)	Notes
Derecognize the carrying amount of the underlying asset	\$(44,000)	\$77,000 original carrying amount – 3 years of depreciation ( $\$77,000 / 7\text{-year useful life} = \$11,000$ )
Derecognize entire unamortized portion of originally capitalized IDCs	(800)	\$2,000 original amount of IDCs capitalized – 3 years of IDCs amortization ( $\$2,000 / 5\text{-year lease term} = \$400$ ) <i>The portion capitalizable under Topic 842 will be included in the net investment in the sales-type lease</i>
Recognize a net investment in the lease as if the lease had been accounted for as a sales-type lease under Topic 842 since lease commencement	45,049	Commencement date net investment in the lease of \$77,800 ( $\$77,000$ fair value of the underlying asset + \$800 in capitalizable IDCs) – three lease payments of \$17,000 + 9.01% interest on the net investment in the lease of \$7,010, \$6,110, and \$5,129 for 2016, 2017 and 2018, respectively
<b>Adjustment to equity</b>	<b>\$ (249)</b>	

Accordingly, LR records the following journal entry.

	Debit	Credit
Net investment in equipment lease	45,049	
Equipment		44,000
Unamortized initial direct costs		800
Retained earnings		249
<i>To recognize sales-type lease on transition.</i>		

After January 1, 2019, LR accounts for the lease in accordance with Topic 842.



### Observation

#### Changes in lessor lease classification in transition

13A.4.140 Consistent with the Observation at paragraph 13A.3.230, we believe it will be relatively infrequent that a lease classified as an operating lease under Topic 840 would be classified as a sales-type or direct financing lease under Topic 842 or vice versa. The same examples outlined in that observation could result in a different classification of an existing lease for lessors if reassessed under the classification criteria in Topic 842, most likely from classification as an operating lease under Topic 840 to classification as a sales-type lease (or, less frequently, to a direct financing lease).

13A.4.150 In addition to those examples, a lease classified as an operating lease under Topic 840 solely because either (1) collectibility of the minimum lease payments was not reasonably predictable, or (2) there were important uncertainties surrounding the amount of unreimbursable costs yet to be incurred by the lessor under the lease would be classified as a sales-type lease under Topic 842. Topic 842 does not preclude sales-type lease classification when there are collectibility uncertainties or when there are uncertainties surrounding unreimbursable costs.

13A.4.160 Consistent with our earlier lessee observations, it appears to us that, where lease classification might change for lessors if reassessed under Topic 842, it is most likely to involve operating leases being reassessed as sales-type or direct financing leases rather than the opposite.



### Observation

#### Initial direct costs included in the net investment in a sales-type or direct financing lease

13A.4.170 If a lessor does not elect the package of practical expedients, it is required to reassess only whether those unamortized initial direct costs at the effective date capitalized in connection with an operating lease under Topic 840 would meet the definition of initial direct costs under Topic 842.

13A.4.180 Initial direct costs capitalized in connection with a direct financing lease under Topic 840<sup>1</sup> are included in the lessor's net investment in the lease. Unamortized amounts are not reassessed even if the lessor does not elect the package of practical expedients. Those amounts are not reassessed because the Board decided that sales-type/direct financing lessors should carry forward the same net investment in the lease they had under Topic 840 to Topic 842 at the effective date. Reassessing unamortized initial direct costs for those leases would have rendered that impossible in most cases given the substantially different definitions of initial direct costs between Topic 840 and Topic 842.

[842-10-65-1(x)(1)]

Note:

1. Initial direct costs are not capitalized in connection with a sales-type lease under Topic 840.



### Question 13A.4.20

#### **Revenue recognition guidance for arrangements that no longer meet the definition of a lease**

### **What revenue recognition guidance does a lessor apply to contracts that no longer meet the definition of a lease on adoption of Topic 842 if it uses the cumulative-effect method to transition to Topic 606?**

**Background:** ABC Corp. adopts Topic 606 on January 1, 2018, using the cumulative-effect method (i.e. rather than the full retrospective method). ABC applies the guidance in Topic 606 to all contracts in 2018 and recognizes the cumulative effect of initial adoption of Topic 606 in the opening balance of retained earnings on January 1, 2018. The adoption of Topic 606 does not affect ABC's accounting for lease arrangements in the scope of Topic 840.

ABC adopts Topic 842 on January 1, 2019, and does not elect the package of practical expedients. On adoption of Topic 842, ABC concludes that an arrangement previously accounted for as a lease under Topic 840 does not meet the definition of a lease under Topic 842. Instead, ABC concludes the arrangement provides a service in the scope of Topic 606. This arrangement commenced in 2017.

**Interpretive response:** On adoption of Topic 842, ABC should apply the guidance in Topic 606 to the arrangement that is no longer a lease, beginning at the effective date. ABC should not restate the comparative periods (i.e. as if the arrangement had been subject to the guidance in Topic 606 for all periods presented).

Because ABC elected the effective date method when adopting Topic 842, the comparative periods continue to be presented in accordance with Topic 840, under which the arrangement in the background was appropriately accounted for as a lease. The effect of adopting Topic 842 (i.e. no longer identifying the arrangement as a lease, and instead accounting for the arrangement as a service contract under Topic 606) should *not* be reflected in the comparative periods. Any cumulative effect resulting from the change should be reflected in

the Topic 842 cumulative effect transition adjustment recorded at the effective date (i.e. January 1, 2019).

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### **13A.4.3 ASU 2018-20, Narrow-Scope Improvements for Lessors**

13A.4.190 ASU 2018-20 (issued December 10, 2018) enacted the following amendments to Topic 842:

- created a lessor-only practical expedient for sales and other similar taxes (see paragraphs 7.3.210 – 7.3.240);
- created accounting for lessor costs and lessee payments thereof that differs based on which party (lessee or lessor) remits payment for the cost to the relevant third party – e.g. the taxing authority or insurer. Paragraphs 7.3.160 – 7.3.200 discuss these requirements; and
- clarified that a lessor should recognize variable payments not included in the consideration in the contract as follows (see section 4.4.3):
  - the portion allocated to the separate lease component, in the period in which the changes in facts and circumstances on which the payment is based occur; and
  - the portion allocated to the non-lease component(s), as revenue when the requirements of the applicable Topic (e.g. Topic 606) are met.

#### ***Entities that did not adopt Topic 842 before issuance of ASU 2018-20***

13A.4.200 Lessors that did not adopt Topic 842 before ASU 2018-20 was issued will adopt the amendments in paragraph 13A.4.190 when they adopt Topic 842. The amendments will apply to all new and existing leases from the date of adoption – e.g. January 1, 2019 for a calendar year-end public business entity. [842-10-65-3(a)]

13A.4.210 A lessor applying the effective date method is not required to recast its income statement presentation for periods before its adoption date (see Question 13A.4.30). Therefore, items may be presented differently in the adoption year than in comparative periods. The following are examples.

- A lessor may have historically presented sales tax collections from lessees on a gross basis in the income statement – i.e. separately from the associated tax cost. If the lessor elects the sales tax practical expedient on adopting Topic 842, it will present all sales tax collections on new and existing leases net of the related tax cost from the date of adoption.
- A lessor may have historically presented lessee reimbursements of property taxes or insurance net of the related costs. From the adoption date of Topic 842, for new and existing leases, it will present all property tax and insurance costs and lessee reimbursements thereof on a gross basis.



## Question 13A.4.30

### Comparative periods

#### Is a lessor permitted to recast comparative periods to conform to its Topic 842 gross vs. net presentation?

**Background:** As outlined in paragraph 13A.4.200, some lessors may be required to change their presentation of lessor costs (e.g. property taxes) and lessee payments thereof on adoption of Topic 842 from how they presented those items historically under Topic 840. This may create noticeable differences between a lessor's adoption year and comparative period financial statements.

#### Topic 840 and SEC guidance

Topic 840 does not prescribe gross or net presentation for lessor costs such as property taxes or insurance or lessee payments thereof, and there is no relevant SEC guidance.

**Interpretive response:** It depends. While Topic 842 would generally not permit recasting the comparative periods, Topic 250 (accounting changes and error corrections) may provide an avenue to do so.

Topic 842 does not permit recasting the comparative periods because, under the effective date method, Topic 842 does not apply before the effective date – i.e. it does not apply to the comparative periods presented. Recasting the comparative periods to, for example, separately present previously netted income statement amounts would, in effect, be selectively applying the comparative period method (see chapter 13B) to adopt the amendments in ASU 2018-20, while using the effective date method to adopt the remainder of Topic 842. [\[842-10-65-1\(c\)\]](#)

Although Topic 842 does not apply to the comparative periods presented when using the effective date transition method, Topic 250 may be considered. A change in gross versus net income statement presentation is a change in accounting principle under Topic 250. And because Topic 840 does not prescribe gross or net income statement presentation for lessor costs and lessee payments thereof, a lessor may be able to justify a change to its comparative periods' gross versus net income statement presentation to conform to its post-effective date presentation as preferable. An entity's facts and circumstances will affect whether or not such a change is preferable, and whether a preferability determination is required for the change. [\[250-10-45-2 – 45-8\]](#)

#### Entities that early adopted Topic 842 before issuance of ASU 2018-20

13A.4.220 Lessors that early adopted Topic 842 will adopt the amendments in ASU 2018-20 as of their mandatory Topic 842 adoption date – e.g. January 1, 2019 for a calendar year-end public business entity. [\[842-10-65-3\(b\)\]](#)

13A.4.230 Alternatively, lessors can elect to apply the amendments to all new and existing leases in either: [\[842-10-65-3\(b\)\]](#)

- the first reporting period ending after the issuance of ASU 2018-20 – e.g. the quarter beginning October 1, 2018 for a calendar year-end public business entity; or
- the first reporting period beginning after the issuance of ASU 2018-20 – e.g. the quarter beginning January 1, 2019 for a calendar year-end public business entity.

13A.4.240 Lessors will apply the amendments either: [842-10-65-3(c)]

- retrospectively to all prior annual and interim periods after the entity's Topic 842 adoption date; or
- prospectively from the entity's adoption date of the amendments.

13A.4.250 An early adopting lessor applying the effective date method is not required to recast its income statement presentation for periods before its Topic 842 adoption date (see Question 13A.4.30).

#### **13A.4.4 ASU 2019-01, Codification Improvements**

13A.4.260 ASU 2019-01 (issued March 5, 2019) enacted the following amendments to Topic 842:

- reinstated guidance from Topic 840 requiring lessors that are not manufacturers or dealers to measure the fair value of the underlying asset at its cost after reflecting any volume or trade discounts applied; cost includes acquisition costs such as sales taxes and delivery and installation costs. An exception arises if there is a significant time lapse between asset acquisition and lease commencement. In those cases, the lessor determines the fair value of the underlying asset in accordance with Topic 820 (fair value measurements). Section 7.3.1 further discusses this guidance; and [842-30-55-17A]
- requires lessors that are depository or lending institutions in the scope of Topic 942 (financial services—depository and lending) to classify the principal portion of lease payments received under sales-type or direct financing leases as cash flows from investing activities. The interest portion of those lease payments and all lease payments received under operating leases are classified as cash flows from operating activities. [842-30-45-5, 942-230-45-4]

13A.4.270 The effective dates of the amendments in ASU 2019-01 are as follows. [842-10-65-4(a)]

Effective date	Public business entities	All other entities
Annual periods – fiscal years beginning after	December 15, 2019	December 15, 2021
Interim periods – in fiscal years beginning after	December 15, 2019	December 15, 2022
Early adoption allowed?	Yes	Yes

13A.4.280 A lessor that does not adopt these amendments as of its Topic 842 adoption date applies them retrospectively from that date. For example, a

calendar year-end public business entity lessor that adopts the amendments on January 1, 2020 retrospectively applies the amendments from its Topic 842 date of adoption of January 1, 2019. [842-10-65-4(b)]

### 13A.4.5 ASU 2021-05, Lessors—Certain Leases with Variable Lease Payments

13A.4.290 ASU 2021-05 (issued July 19, 2021) requires a lessor to classify a lease with variable lease payments that do not depend on an index or rate as an operating lease if: [842-10-25-3A]

- the lease would have been classified as a sales-type lease or a direct financing lease under the pre-ASU classification criteria; and
- sales-type or direct financing classification would result in a commencement date loss.

13A.4.300 The effective dates of the amendments in ASU 2021-05 are as follows. [842-10-65-5]

Effective date	Public business entities	Other entities
Annual periods – fiscal years beginning after	December 15, 2021	December 15, 2021
Interim periods – in fiscal years beginning after	December 15, 2021	December 15, 2022
Early adoption allowed?	Yes, but not before adopting ASC 842.	

13A.4.310 The available transition approaches depend on the entity's Topic 842 adoption status as of July 19, 2021 (i.e. the issuance date of ASU 2021-05).

- **Lessors that have not yet adopted Topic 842** will adopt the amendments in ASU 2021-05 at the same time and using the same transition method they use to adopt Topic 842 – either the effective date method or the comparative method (see chapters 13A and 13B, respectively).
- **Lessors that have already adopted Topic 842** will apply the amendments in ASU 2021-05 either:
  - retrospectively to leases that commenced or were modified on or after the entity's adoption of Topic 842 (e.g. on January 1, 2019 for a calendar-year public business entity); or
  - prospectively to leases that commence or are modified (and that modification is not accounted for as a separate contract) after the entity adopts the ASU 2021-05 amendments.

### 13A.4.6 ASU 2023-01, Common Control Arrangements

13A.4.320 ASU 2023-01 (issued March 27, 2023) contains amendments to Topic 842 around two issues that apply to arrangements between entities under

common control. Only the amendments related to the first of those two issues (**Issue 1**) applies to lessors.

13A.4.330 The effective dates of the Issue 1 amendments in ASU 2023-01 are as follows. [842-10-65-7]

Effective date	All entities
Annual periods – fiscal years beginning after	December 15, 2023
Interim periods – in fiscal years beginning after	December 15, 2023
Early adoption allowed?	Yes, in any annual or interim period, as of the beginning of the fiscal year, for which financial statements have not yet been made available for issuance
Entities that have not issued (or made available for issuance) financial statements under Topic 842 before final ASU was issued	May adopt concurrent with Topic 842

13A.4.340 The Issue 1 amendments permit a private entity (lessee or lessor) to elect a practical expedient to use the written terms and conditions, as opposed to the legally enforceable terms and conditions, of a common control leasing arrangement to determine whether a lease exists and, if so, to determine the classification of and accounting for that lease. See section 3.1.2. [842-10-15-3A]

13A.4.350 The available transition approaches depend on the entity's Topic 842 adoption status as of March 27, 2023 (i.e. the issuance date of ASU 2023-01). [842-10-65-7]

- **Private entities that have not yet issued (or made available for issuance) financial statements under Topic 842** have the option to adopt the amendments in their first Topic 842 compliant financial statements and use the same transition method as they used to adopt the remainder of Topic 842 (i.e. the effective date method – for the comparative method, see chapter 13B).
- **Private entities that have already applied Topic 842 in financial statements that have been issued (or made available for issuance)** have the option to adopt the amendments:
  - prospectively to common control arrangements that commence or are modified on or after the entity's adoption date of the ASU (e.g. January 1, 2024 if a calendar year entity that does not early adopt the amendments); or
  - on a modified retrospective basis to all leases that exist at the entity's adoption of the ASU.

Under the modified retrospective transition approach, the entity records the effect of adopting the amendments through a cumulative-effect adjustment to retained earnings at the beginning of the earliest period presented in the financial statements.

For example, assume that a calendar year private entity adopted Topic 842 on January 1, 2022; adopted the Issue 1 amendments on January 1, 2024; and is issuing financial statements that will present 2023 and 2024. Under this transition approach, the entity would record the required cumulative-effect adjustment as of January 1, 2023 (beginning of earliest period presented), but based on an assumed retrospective application as of January 1, 2022 (Topic 842 adoption date) to common control arrangements still in place at January 1, 2024.

## 13A.5 Applying the guidance on components of a contract in transition

13A.5.10 Neither the transition guidance in Topic 842, nor the ASU 2016-02 basis for conclusions, explicitly discuss the effect of the new guidance on identifying, separating and allocating the ‘consideration in the contract’ to components of a contract (see chapter 4) on transition.

13A.5.20 However, we believe the requirements with respect to the new components guidance in transition can be derived from other requirements in the transition guidance. Sections 13A.5.1 and 13A.5.2 describe what we believe the effect (or non-effect) of this guidance is on the various transition scenarios presented, assuming the entity previously appropriately applied the guidance in Topic 840 with respect to (1) identifying lease and non-lease elements and (2) separating elements and allocating contract consideration. As discussed in Question 13A.2.100, the transition guidance in Topic 842 does not grandfather prior errors in applying Topic 840.

13A.5.30 Each of these scenarios assumes that the lease is *not* modified (lessees and lessors) or remeasured (lessees only) on or after the effective date. If a lease is modified (and that modification is not accounted for as a separate contract) or remeasured on or after the effective date, all of the requirements of Topic 842 become applicable to that lease, including the guidance on accounting for components of a contract.

### 13A.5.1 Lessee guidance

#### *Operating → Operating*

13A.5.40 Lessees will not reevaluate their previous allocations to lease and non-lease elements of a contract. This is because, absent a post-effective date modification or remeasurement, the transition guidance requires lessees to use the ‘minimum rental payments’ determined in accordance with Topic 840 to account for the lease (see Question 13A.3.10). Revising previous decisions with respect to identification, separation and/or allocation of contract consideration would change the amounts used to account for the lease, directly contradicting the explicit requirement to account for the lease based on the minimum rental payments as determined under Topic 840.

## ***Operating → Finance***

13A.5.50 The transition guidance applicable to this scenario requires the lessee to recognize and measure a new finance lease liability in the same way as for an operating lease that remains classified as an operating lease, and to derive the new finance lease ROU asset from the finance lease liability at the commencement date (see section 13A.3.2).

13A.5.60 Measurement of the lease liability is based on the minimum rental payments (as defined in Topic 840). Revising previous decisions with respect to identification, separation and/or allocation of contract consideration would change the amounts used to account for the lease, contradicting the explicit requirement to account for the lease based on the minimum rental payments as determined under Topic 840.

## ***Finance → Finance***

13A.5.70 Lessees will not reevaluate their previous allocations to lease and non-lease elements of a contract. This is because the transition guidance requires lessees to measure the initial finance lease ROU asset and initial finance lease liability at the same amounts recognized immediately before the effective date for the capital lease asset and the capital lease obligation, respectively (except as noted in Question 13A.2.50).

13A.5.80 In addition, absent a post-effective date modification or remeasurement, lessees will not remeasure those amounts; they will simply complete the accounting for the lease based on those initially measured amounts. Similar to the operating lease to operating lease scenario in paragraph 13A.5.40, revisions to decisions made about components of the contract would require the lessee not to follow the explicit measurement requirements for this scenario.

## ***Finance → Operating***

13A.5.90 The transition guidance applicable to this scenario requires the lessee to derecognize its existing capital lease asset and capital lease obligation and, at the effective date, recognize and measure a new operating lease liability in accordance with Topic 842 and derive the new operating lease ROU asset from that lease liability (see paragraphs 13A.3.210 – 13A.3.220).

13A.5.100 Measurement of the lease liability in accordance with Topic 842 is based on the lease payments. Because the lease payments are a function of the separation and allocation guidance in Topic 842 if there are either (1) multiple separate lease components or (2) lease and non-lease components of the contract, lessees will need to apply the Topic 842 multiple-component separation and allocation guidance (see section 4.4) to comply with the transition measurement requirements.



### Question 13A.5.10

#### **Not separating lease from non-lease components on transition**

#### **Is the practical expedient for a lessee to not separate lease and non-lease components a policy election available to lessees for existing leases?**

**Background:** As a practical expedient, a lessee may elect not to separate non-lease components from the lease components to which they relate. A lessee applies this practical expedient as an accounting policy election by class of underlying asset – e.g. office equipment, automobiles, office space. However, there is no mention in Topic 842 as to whether a lessee could similarly apply this expedient on transition. [842-10-15-37]

**Interpretive response:** Yes. While not explicitly provided for in the transition guidance, we believe lessees are permitted to make an accounting policy election (by class of underlying asset) to not separate non-lease elements (e.g. substantial services such as those to operate the asset) from the lease elements to which they relate for existing leases.

For example, a lessor's operation of the underlying asset (e.g. services to operate a ship or an airplane) is an example of a substantial service that is accounted for separate from the lease element. Therefore, in an operating lease, a lessee electing the non-separation practical expedient for existing leases on transition will account for fixed costs allocable to the operation services as part of the minimum rental payments that are used to measure the operating lease liability.

The Board decided to permit the non-separation practical expedient for leases that commence on or after the effective date to ease the accounting for lessees, and many of the transition provisions were similarly intended. Therefore, we believe it is acceptable for lessees to apply the expedient to existing leases on transition.



### Question 13A.5.20

#### **Accounting policy implications of separating lease from non-lease components on transition**

#### **If a lessee does not elect the lease/non-lease component practical expedient on transition, is this a binding accounting policy election going forward for new leases that commence after the effective date?**

**Interpretive response:** No. We do not believe there is a basis in Topic 842 for prohibiting a lessee from electing the practical expedient for new leases that commence on or after the effective date solely because it did not elect to apply the practical expedient on transition, application of which is not addressed in Topic 842 or ASU 2016-02 (see Question 13A.5.10).

However, based on related discussions with the SEC staff, we believe a lessee should only apply the lease/non-lease practical expedient to existing leases on transition if it will do so for new leases of underlying assets within the same class commencing on or after the effective date of Topic 842.

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### **13A.5.2 Lessor guidance – practical expedient for separation of lease and non-lease components does not apply**

#### ***Operating → Operating***

13A.5.110 The transition guidance requires lessors in this scenario to continue to recognize the underlying asset, as well as any other lease assets and liabilities (e.g. accrued rent assets or deferred rent liabilities), at the same amounts as immediately before the effective date under Topic 840 (see paragraph 13A.4.20). If a contract that contains an operating lease includes multiple lease components and/or lease and non-lease components, revising the units of account and revising the allocation of the consideration in the contract (which might be different from the total contract consideration under Topic 840 if there are variable payments that specifically relate to non-lease components of the contract) would likely result in adjustments to any recognized lease assets or liabilities – i.e. a change would have resulted in a change to the lease payments, and therefore the accrued/deferred rent amount would typically be measured differently from that which resulted under Topic 840.

#### ***Sales-type/direct financing → Sales-type/direct financing***

13A.5.120 Lessors will not reevaluate their previous allocations to lease and non-lease elements of a contract. This is because the transition guidance requires lessors to measure their initial lease assets under Topic 842 at the same amount recognized immediately before the effective date under Topic 840 (see paragraph 13A.4.40).

13A.5.130 In addition, absent a post-effective date modification not accounted for as a separate contract, lessors in this scenario will not remeasure their lease assets, they will simply complete the accounting for the lease based on the initially measured amount for the net investment in the lease.

#### ***Operating → Sales-type/direct financing; or Sales-type/direct financing → Operating***

13A.5.140 The transition guidance states for either of these scenarios that “the objective is to account for the lease, beginning on the application date ... as if it had always been accounted for as an operating [a sales-type or direct financing] lease in accordance with this Topic” (see paragraphs 13A.4.80 and 13A.4.120). It therefore seems clear that this would include reassessing the lessor’s accounting with respect to the components of the contract.



### Question 13A.5.30

#### **Topic 842 and Topic 606 interaction in accounting for CAM**

#### **How should a lessor account for CAM provided in a lease after it adopts Topic 606 but before it adopts Topic 842?**

**Background:** Topic 840 specifies that CAM is within its scope based on the following. [840-10-25-1(d), 15-17, 15-19(a)]

- It describes maintenance as an executory cost.
- It states that “if an arrangement contains a lease and related executory costs, as well as other non-lease elements, the classification, recognition, measurement, and disclosure requirements of this Topic shall be applied by both the purchaser and the supplier to the lease element of the arrangement.” [emphasis added]
- It characterizes related executory costs as part of ‘those for the lease’.

#### **Interpretive response:**

##### **Accounting for existing leases before the effective date of Topic 842**

Topic 606 is a ‘residual standard’ in that it requires the application of other Topics first if those other Topics specify how to account for one or more parts of the contract. Topic 606 only applies to those parts of the contract that other Topics do not address.

CAM expenditures are described as ‘executory costs’, and accounted for as part of the lease element under Topic 840. Therefore, CAM is not governed by Topic 606 for leases that commence before the effective date of Topic 842, and an entity may continue to account for CAM under its historical accounting policy. That said, on the adoption of Topic 606, based on discussions with the FASB and SEC staffs, we believe it would be acceptable for an entity to either (or both): [606-10-15-4]

- analogize to the guidance in Topic 606 in determining the measure of progress to apply when recognizing CAM revenue – i.e. rather than follow its historical accounting policy for recognizing CAM; and/or
- separately present CAM revenues as non-lease revenue. If a lessor decides to separately present CAM revenue as non-lease revenue, it is acceptable to allocate revenue between the lease and CAM using either: (1) the requirements in Topic 840 or (2) the transaction price allocation guidance in Topic 606 (see paragraphs 13A.5.150 – 13A.5.160). On adoption of Topic 842, that separate presentation (if elected) should be reflected in the comparative periods presented.

##### **Accounting for existing leases after the effective date of Topic 842**

Assuming that lease classification is the same before and after adoption of Topic 842 (unless the lease is modified on or after the effective date and that modification is not accounted for as a separate contract), the lessor will not reevaluate the identification of and allocation to lease and non-lease components (see paragraphs 13A.5.110 – 13A.5.130). The lessor will continue

to account for CAM provided as part of the lease contract just as it did before the effective date of Topic 842 (see above).

### **Accounting for leases that commence or are modified on or after the effective date of Topic 842**

For all leases that commence or are modified on or after the effective date of Topic 842 (and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8), the lessor will identify CAM as a non-lease component and account for it under Topic 606.



#### Observation

##### **Lessor reallocation may be permissible in some cases**

13A.5.150 The discussion in paragraphs 13A.5.110 – 13A.5.130 notwithstanding, the SEC staff has communicated that they may not object to a lessor beginning to account for maintenance services (including common area maintenance), which is a lease-related element under Topic 840, as a non-lease element beginning with the lessor's adoption of Topic 606 if the lessor adopts Topic 606 before it adopts Topic 842. Under this approach, we believe the lessor would account for those services as within the scope of Topic 606 and would allocate the contract consideration between the remaining lease elements and any non-lease elements (including maintenance services) in accordance with the transaction price allocation guidance in paragraphs 606-10-32-28 – 32-41.

13A.5.160 The lessor's accounting in this regard would follow the lessor's Topic 606 transition approach (full retrospective approach or cumulative effect approach).

13A.5.170 Taken as a whole, we believe entities will only be required to reassess their identification and accounting for components of a contract when the lease classification changes as a result of applying Topic 842 to the lease. If lease classification does not change or the entity elects the package of practical expedients, which means the entity will not reassess classification of its leases under Topic 842, entities will not be required to reassess their identification of or accounting for multiple components of a contract. Avoiding the effort to reassess the accounting for components of a contract and avoiding the operational complexities that could arise from that exercise if classification of a lease does change is another reason many entities will likely consider electing the package of practical expedients.

13A.5.180 However, consistent with the discussion in Question 13A.2.100 about identifying leases, the ability to not reassess identification of or accounting for multiple components of a contract presumes the entity applied the guidance in Topic 840 completely and accurately. For example, if an entity did not appropriately identify lease and non-lease elements, or did not appropriately separate 'minimum rental payments' or 'minimum lease payments' from payments for non-lease elements (e.g. services), the transition guidance does not excuse those errors.



### Question 13A.5.40

#### **Existing arrangements with lease and non-lease elements – substantial services**

##### **What guidance applies to a lessor when accounting for 'substantial services' provided to a lessee on transition?**

**Background:** Topic 840 required a lessor to separate, at lease inception, payments and other consideration into those: [840-10-15-19]

- related to the lease, including the related executory costs; and
- for other services.

Under Topic 840, the term 'executory costs' referred to the normal expenses associated with owning an asset, including insurance, maintenance and taxes. Therefore, activities identified as giving rise to executory costs, such as most maintenance services, were not non-lease elements. 'Substantial services' were accounted for separately from the lease (under Topic 605 before the adoption of Topic 606). [840-10-25-1(d), 840-10-15-8 – 15-19]

Before the adoption of Topic 606, the components were required to be separated on a relative selling price basis. After the adoption of Topic 606, lessors separate lease from non-lease components (which includes substantial service elements) using the transaction price allocation guidance in Topic 606. [840-10-15-19]

**Interpretive response:** Substantial services were non-lease elements under Topic 840. Therefore, before the lessor's adoption of Topic 606 they were required to be accounted for under Topic 605 (or other relevant pre-Topic 606 revenue guidance). Consequently, substantial services become subject to Topic 606 for lessors on transition to Topic 606, and should be transitioned using the same guidance that applies to all other elements that were subject to the pre-Topic 606 revenue guidance. The consideration in the lease contract, however, is not reallocated between the lease and non-lease elements on adoption of Topic 606 and the lessor continues to use the consideration allocated to the non-lease component based on the Topic 840 allocation guidance (see also Question 13A.5.30).

If substantial service elements were accounted for as being in the scope of Topic 840 (i.e. as part of a lease element), this is a non-GAAP accounting policy that is subject to financial statement materiality considerations. There is no practical expedient in transition to Topic 606 that would permit a substantial service element to be accounted for as part of a lease after the adoption of Topic 606.

##### **Lessor practical expedient not to separate lease and non-lease components**

As discussed in section 13A.5.3, a lessor that elects the non-separation practical expedient for lease and non-lease components will combine lease and substantial service elements in existing leases that meet the specified criteria (see paragraph 13A.5.190) prospectively beginning:

- For non-early adopters, on the effective date of Topic 842; and
- For early adopters:

- either (1) in the first reporting period following the issuance of ASU 2018-11 (e.g. the beginning of the fiscal quarter following the issuance date of the ASU) or (2) at the entity's mandatory Topic 842 adoption date (e.g. January 1, 2019 for a calendar year-end public business entity); and
- retrospectively to all prior annual and interim periods after the entity's Topic 842 adoption date.

For example, a lessor is not early adopting Topic 842 and will combine its ship lease and operations services elements for new leases under Topic 842. In that case, the lessor will also present ship lease and operations service (i.e. substantial service) revenue for *existing* leases on a combined basis beginning on the effective date of Topic 842. That same lessor, applying the effective date method, is not required to combine the lease and substantial operation service elements for presentation purposes in its comparative period financial statements (see Question 13A.5.50).

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### **13A.5.3 Lessor guidance – practical expedient for separation of lease and non-lease components applies**

13A.5.190 Topic 842 provides a lessor practical expedient whereby the lessor can make an accounting policy election, by class of underlying asset, not to separate lease and related non-lease components if both: [842-10-15-42A]

- the timing and pattern of transfer to the lessee of the lease component and the non-lease component(s) associated with that lease component are the same; and
- the lease component, if accounted for separately, would be classified as an operating lease.

13A.5.200 Paragraphs 4.4.51 – 4.4.56 discuss the lessor practical expedient in detail.

#### ***Entities that have not adopted Topic 842 on issuance of ASU 2018-11***

13A.5.210 Lessors that had not early adopted Topic 842 when ASU 2018-11 was issued may elect the practical expedient when they adopt Topic 842.

13A.5.220 For existing leases (i.e. those that commence before the adoption of Topic 842), lessors will apply the non-separation practical expedient from the effective date. That is, a lessor will combine lease and non-lease components arising from an existing lease if they would also do so if the lease were a new lease that commenced on or after the entity's adoption date. [842-10-65-2(a)X])

13A.5.230 A lessor applying the effective date method is not required to recast its income statement presentation for periods before its adoption date (see Question 13A.5.50).

## **Entities that early adopted Topic 842 before the issuance of ASU 2018-11**

13A.5.240 Lessors can elect the practical expedient at either:

- the beginning of the entity's first reporting period following the issuance of ASU 2018-11 – e.g. the beginning of the fiscal quarter following the issuance date of the ASU; or
- at the entity's mandatory Topic 842 adoption date – e.g. January 1, 2019 for a calendar year-end public business entity.

13A.5.250 For existing leases (i.e. those that commence before the lessor's adoption of the practical expedient), lessors will apply the non-separation practical expedient either:

- retrospectively to all prior annual and interim periods *after the entity's Topic 842 adoption date*; or
- prospectively from the date of the entity's adoption of the practical expedient.

13A.5.260 An early adopting lessor applying the effective date method is not required to recast its income statement presentation for periods before its Topic 842 adoption date (see Question 13A.5.50).



### Question 13A.5.50

#### **Combining lease and non-lease components in comparative periods**

### **Is a lessor permitted to recast comparative periods to conform to its Topic 842 presentation of revenue from lease and qualifying non-lease components?**

**Background:** Many lessors have presented lease and non-lease revenue separately in their historical financial statements that they will account for as part of a combined component under Topic 842 because of the lessor non-separation practical expedient (see paragraphs 13A.5.190 – 13A.5.200). For example, under Topic 840, a lessor may have presented lease revenue separately from revenue from operating or other substantial services in the income statement.

Additionally, under Topic 840, many lessors have presented base rent revenue separately from lease-related revenue arising from executory costs in the income statement. For example, a real estate lessor may have presented base rental revenue (i.e. from the minimum rental payments) separate from fixed CAM charges or variable tenant CAM reimbursements.

Because Topic 842 does not apply to periods before the date of adoption for lessors using the effective date method of transition (comparative periods remain subject to Topic 840), the question arises as to whether a lessor using the effective date method is *permitted* to recast its income statement presentation for the comparative periods pre-Topic 842 adoption to conform to

its combined presentation post-adoption. We believe it is clear that a lessor is not *required* to do so. [842-10-65-1(c)]

Topic 840 requires lease and non-lease (i.e. goods or substantial service) elements to be accounted for separately and there is no practical expedient that permits lessors to account for them on a combined basis. Topic 840 does not, however, provide guidance on how such lease and non-lease revenue must be presented in the income statement. [840-10-15-19]

However, SEC guidance in Regulation S-X requires issuer entities to present income from rentals (i.e. lease revenue) separately from sales and service revenue in the income statement. [Reg S-X, Rule 5-03(b)]

**Interpretive response:** Despite Topic 842 not applying to periods before the date of adoption for lessors using the effective date method of transition, a lessor may still be permitted to do so. However, the specific lease and non-lease components for which it would be acceptable for a lessor to recast its comparative period income statement presentation differ if the lessor is an SEC registrant.

### Non-SEC registrants

Topic 842 does not apply to the comparative periods presented when using the effective date method. Therefore, Topic 250 (accounting changes and error corrections) should be considered.

We do not believe a change in income statement aggregation or disaggregation is a change in accounting principle under Topic 250 if both the previous and the new aggregations are acceptable under the applicable US GAAP – i.e. Topic 840 in this instance. And because Topic 840 does not specify separate or combined income statement presentation for the revenue items discussed in the background, we believe either was acceptable under Topic 840.

If a lessor changes its income statement aggregation for the comparative periods, the notes to the financial statements should disclose the change. We do not believe a preferability assessment under Topic 250 is required.

### SEC registrants

We believe our response for non-SEC registrants also applies to SEC registrants if, and only if, the item presented separately from lease revenue was an executory cost element (e.g. maintenance, including CAM), rather than a non-lease element (i.e. goods or a substantial service), under Topic 840.

However, because of the guidance in SEC Regulation S-X applicable to SEC registrants, we do not believe income statement presentation of lease and non-lease goods or substantial service revenues on a combined basis was an acceptable accounting alternative for those lessors. Therefore, a lessor is not permitted to change its comparative period income statements to combine revenues from leases and non-lease goods or substantial services.

We do not believe lessee payments of executory costs were required to be presented separately from lease revenue under Regulation S-X because Topic 840 characterizes those payments as part of ‘those for the lease’ (see Question 13A.5.30).

## 13A.6 Leveraged leases



### Excerpt from ASC 842-10

#### 65 Transition and Open Effective Date Information

##### General

> Transition Related to Accounting Standards Updates No. 2016-02, *Leases (Topic 842)*, No. 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*, No. 2018-10, *Codification Improvements to Topic 842, Leases*, No. 2018-11, *Leases (Topic 842): Targeted Improvements*, No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, 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*, No. 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*, No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*, No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*, and No. 2023-01, *Leases (Topic 842): Common Control Arrangements*

**65-1** The following represents the transition and effective date information related to Accounting Standards Updates No. 2016-02, *Leases (Topic 842)*, No. 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*, No. 2018-10, *Codification Improvements to Topic 842, Leases*, No. 2018-11, *Leases (Topic 842): Targeted Improvements*, No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, 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*, No. 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*, No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*, No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*, and No. 2023-01, *Leases (Topic 842): Common Control Arrangements*: [Note: See paragraph 842-10-S65-1 for an SEC Staff Announcement on transition related to Update 2016-02.]

#### Leases previously classified as leveraged leases under Topic 840

- z. For leases that were classified as **leveraged leases** in accordance with Topic 840, and for which the commencement date is before the effective date, a lessor shall apply the requirements in Subtopic 842-50. If a leveraged lease is modified on or after the effective date, it shall be accounted for as a new lease as of the effective date of the modification in accordance with the guidance in Subtopics 842-10 and 842-30.
  - 1. A lessor shall apply the pending content that links to this paragraph to a leveraged lease that meets the criteria in (z) that is acquired in a business combination or an **acquisition by a not-for-profit entity** on or after the effective date.

13A.6.10 For leases classified as leveraged leases under Topic 840 and for which the commencement date is before the effective date, a lessor continues its existing leveraged lease accounting, even if the lessor does not elect the package of transition practical expedients. However, if a leveraged lease is modified on or after the effective date, it is accounted for as a new lease at the modification date in accordance with Topic 842. [842-10-65-1(z)]

13A.6.20 If a lessee exercises an option to extend a leveraged lease that commenced before the effective date of Topic 842 for which exercise was not previously considered reasonably assured, the exercise of that option is considered a lease modification. [842-50-15-1]

13A.6.30 For further discussion of leveraged leases, see section 7.8.



### Question 13A.6.10 Acquired leveraged leases

#### If a leveraged lease is acquired, does the lessor continue to apply leveraged lease accounting?

**Background:** The lease could be acquired separately, or as part of a business combination (or an acquisition by a not-for-profit entity).

**Interpretive response:** Yes, provided that the lease is not modified as part of the acquisition. The lessor will continue to apply the leveraged lease guidance in Subtopic 842-50 (leveraged lease arrangements) (see section 7.8).

## 13A.7 Sale-leaseback transactions



### Excerpt from ASC 842-10

#### 65 Transition and Open Effective Date Information

##### General

> Transition Related to Accounting Standards Updates No. 2016-02, *Leases (Topic 842)*, No. 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*, No. 2018-10, *Codification Improvements to Topic 842, Leases*, No. 2018-11, *Leases (Topic 842): Targeted Improvements*, No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, 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*, No. 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*, No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*, No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*, and No. 2023-01, *Leases (Topic 842): Common Control Arrangements*

**65-1** The following represents the transition and effective date information related to Accounting Standards Updates No. 2016-02, *Leases (Topic 842)*, No. 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*, No. 2018-10, *Codification Improvements to Topic 842, Leases*, No. 2018-11, *Leases (Topic 842): Targeted Improvements*, No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, 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*, No. 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*, No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*, No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*, and No. 2023-01, *Leases (Topic 842): Common Control Arrangements*: [Note: See paragraph 842-10-S65-1 for an SEC Staff Announcement on transition related to Update 2016-02.]

### 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.
- ee. If a previous sale and leaseback transaction was accounted for as a sale and operating leaseback in accordance with Topic 840, the transferor shall do the following:
1. Recognize any deferred gain or loss not resulting from off-market terms (that is, where the consideration for the sale of the asset is not at **fair value** or the lease payments are not at market rates) as a cumulative-effect adjustment 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)).

13A.7.10 If a sale-leaseback transaction was previously accounted for as a sale and a leaseback under Topic 840, an entity does not reassess whether the transaction would have qualified as a sale (or purchase) under Topic 842. This means that buyer-lessors will not revisit whether a purchase of the underlying asset occurred for any sale-leaseback transactions for which the sale/purchase occurred before the effective date. [842-10-65-1(aa)]

13A.7.20 An entity accounts for the leaseback in accordance with the lessee and lessor transition requirements outlined in sections 13A.2 – 13A.5. [842-10-65-1(cc)]

13A.7.30 If a transaction was previously accounted for as a sale and capital (finance) leaseback under Topic 840, a seller-lessee continues to amortize any deferred gain or loss existing at the effective date as follows. [842-10-65-1(dd)]

- If the asset is land only, over the remaining lease term on a straight-line basis.
- If the asset is not land only:
  - in proportion to the amortization of the ROU asset if the leaseback is a finance lease; and
  - in proportion to total lease cost recognized in profit or loss if the leaseback is an operating lease.

13A.7.40 If a transaction was previously accounted for as a sale and operating leaseback under Topic 840, a seller-lessee (see Example 13A.7.20):  
[\[842-10-65-1\(ee\)\]](#)

- recognizes the portion of any deferred gain or loss not resulting from off-market terms as a cumulative-effect adjustment to equity at the effective date; and
- recognizes the portion of any deferred gain or loss that resulted from off-market terms as an adjustment to the leaseback ROU asset (if the sales price was below market) or as a remaining financial liability (if the sales price was above market) at the effective date.

13A.7.50 Consistent with the transition requirements for lessees and lessors, the sale-leaseback transition requirements generally limit the implementation cost and complexity for preparers. A seller-lessee will recognize an adjustment to equity on transition only for sale and operating leasebacks for which there is a deferred gain or loss not resulting from off-market terms.

13A.7.60 If a previous sale-leaseback transaction was, and continues to be at the effective date, accounted for as a failed sale under Topic 840, the entity reassesses whether a sale has occurred as of the effective date in accordance with Topic 842. If so, the seller-lessee recognizes the sale as an adjustment to equity at that date. The leaseback is subsequently accounted for in the same manner as any other seller-lessee leaseback (see section 9.2.3) from the effective date. [\[842-10-65-1\(bb\)\(2\)\]](#)



### Question 13A.7.10

#### **Leaseback accounting in transition for previously failed sales**

**What is the seller-lessee's accounting for a sale-leaseback transaction that remains a failed sale under Topic 840 at the effective date?**

**Interpretive response:**

##### **Accounting for the sale**

If the sale criteria in Subtopic 842-40 (see section 9.1) are met as of the effective date (because as of that point in time there are no conditions precluding a sale under Subtopic 842-40), the gain or loss on the sale of the underlying asset should be recognized as an adjustment to equity as of that date. [\[842-10-65-1\(bb\)\(2\)\]](#)

The guidance in section 9.2 applies if the sale criteria in Subtopic 842-40 are met after the effective date of Topic 842.

### **Accounting for the leaseback**

If the sale criteria in Subtopic 842-40 are met as of the effective date of Topic 842, the accounting for the leaseback should follow the transition provisions discussed in sections 13A.2 and 13A.3.

If the entity has elected the package of transition practical expedients (see section 13A.2.3), we believe the preceding paragraph means the following.

- Because this was previously determined to be a failed sale-leaseback transaction, there would be no additional consideration as to whether the leaseback meets the definition of a lease under Topic 842.
- Because there was no lease accounted for under Topic 840 (i.e. because the transaction was accounted for as a failed sale-leaseback) the lessee had not classified the lease under Topic 840. In the absence of specific guidance in Topic 842, we believe it is acceptable for the lessee to assess classification of the lease as of either:
  - the lease commencement date, using the lease classification guidance in Topic 842; or
  - the lease inception date, using the lease classification guidance in Topic 840.

We believe the first approach is acceptable, even though the package of practical expedients has been elected, because there was no 'existing lease' that had previously been classified under Topic 840. However, we believe that to apply this approach, the entity must determine the commencement date of the leaseback (i.e. when a sale would have successfully occurred) under Topic 842.

Alternatively, we believe the second approach is acceptable because election of the package of transition practical expedients effectively grandfathered the legacy Topic 840 classification guidance, which required lease classification to be assessed as of lease inception.

We believe an entity's chosen approach should be applied consistently to all similar circumstances.

- Any unamortized initial direct costs capitalized because the transaction was accounted for as a failed sale will not be reassessed, despite the fact that those costs may have been expensed as transaction costs of the sale had the transaction been a successful sale and leaseback under Topic 840. Those costs will be accounted for by the lessee in the same manner as any other unamortized initial direct costs are accounted for by lessees that elect the package of transition practical expedients.



### Question 13A.7.20

#### **Successful sale-leaseback transactions that include seller-lessee repurchase options on adoption of Topic 606**

**Is a transaction accounted for as a sale and a leaseback under Topic 840 that includes a seller-lessee repurchase option reassessed as a financing arrangement because of the repurchase agreements guidance in Topic 606?**

**Background:** This question arises because Topic 606 states that if an entity has an obligation (a forward) or a right (a call option) to repurchase an asset, then the customer does not obtain control of the asset – i.e. no sale occurs for revenue recognition purposes. An entity accounts for the contract as a lease or a financing arrangement depending on the relationship between the repurchase amount and the original selling price. Further, if the contract is part of a sale-leaseback transaction, the entity should account for the contract as a financing arrangement. [606-10-55-68, ASU 2014-09.BC426]

In contrast, the transition guidance in Topic 842 states that if a previous sale-leaseback transaction was accounted for as a sale and a leaseback in accordance with Topic 840, an entity does not reassess the transaction to determine whether the transfer of the asset would have been a sale. In addition, the sale-leaseback guidance in Subtopic 840-40 was not amended by ASU 2014-09 (or any of the subsequent revenue ASUs) such that all sale-leaseback transactions remain within its scope until Topic 842 is adopted and no guidance to refer to Topic 606 in the case of a seller-lessee repurchase option was added. [842-10-65-1(aa), 840-40-05-1]

**Interpretive response:** No. We believe a successful sale-leaseback transaction under Topic 840 should not be reassessed on transition to Topic 842. This is because of the combination of the transition guidance in Topic 842 (clearly delineating the Board's intent with respect to successful sale-leaseback transactions) plus the fact that Subtopic 840-40 was not amended by any of the revenue ASUs. We believe this to be the case even if the transaction includes a seller-lessee repurchase option. [842-10-65-1(aa), 840-40-05-1]

We believe this conclusion is further supported for sale-leaseback transactions with noncustomers by the fact that Subtopic 610-20 on the derecognition of nonfinancial assets (as amended by ASU 2017-05) specifically excludes from its scope any sale-leaseback transactions that were in the scope of Subtopic 840-40. [610-20-15-4(c)]



### Example 13A.7.10

#### **Sale-leaseback transaction previously accounted for as a sale and an operating leaseback under Topic 840**

The following summarizes relevant information about Seller-Lessee SL's equipment sale-leaseback transaction with Buyer-Lessor BL. The transaction qualified as a sale and a leaseback – i.e. there was no failed sale.

Sale-leaseback transaction date:	January 1, 2018
Leaseback term:	5 years
Leaseback payments (annual, paid in arrears):	\$15,000
Sales price and fair value of equipment at transaction date:	\$115,000
Carrying amount of equipment at transaction date:	\$80,000
Remaining economic life of the equipment at transaction date:	9 years
Leaseback classification:	Operating lease
Initial direct costs:	None
Lessee residual value guarantee:	None

There is no automatic reversion of ownership to SL, nor does SL have an option to repurchase the equipment. SL retains more than a minor portion, but less than substantially all, of the remaining use of the equipment. Therefore, because the profit on the sale does not exceed the present value of the minimum lease payments under Topic 840, the entire gain of \$35,000 is deferred and will be recognized over the five-year leaseback term.

#### **Effective date and transition**

SL and BL are calendar year-end public business entities that adopt Topic 842 on January 1, 2019.

SL and BL do not reassess whether the transaction would have qualified for sale/purchase accounting under Topic 842. BL does not adjust its previous accounting for the purchase of the asset in any manner. On the Topic 842 effective date, SL will recognize the remaining amount of the deferred profit on the sale-leaseback transaction to equity.

	<i>Debit</i>	<i>Credit</i>
Deferred profit on sale-leaseback transaction	28,000	
Retained earnings		28,000
<i>Recognize unamortized deferred gain on transaction at effective date (January 1, 2019).</i>		

#### **Subsequent accounting for the leaseback**

SL and BL account for the leaseback using the transition guidance discussed in sections 13A.2 – 13A.5.



### Example 13A.7.20

#### Sale-leaseback deferred gains and losses in transition

Seller-Lessee SL entered into a sale-leaseback transaction under Topic 840 that qualified as a sale and operating leaseback. The following scenarios illustrate SL's treatment of the deferred gain or loss in transition under the requirements described in paragraph 13A.7.40.

The sale occurred immediately before the effective date of Topic 842, so that any deferred gain or loss on the sale under Topic 840 has not been amortized when evaluating the transition adjustment.

Sale and operating leaseback transaction		Deferred gain/loss transition adjustment		
<i>Deferred gain scenarios</i>				
Fair value	\$100			
Sale price	\$110			
Carrying amount	\$105			
<b>Deferred gain</b>	<b>\$ 5</b>			
			<i>Debit</i>	<i>Credit</i>
		Deferred gain	\$5	
		Financial liability		\$5
Fair value	\$100			
Sale price	\$100			
Carrying amount	\$ 95			
<b>Deferred gain</b>	<b>\$ 5</b>			
		Deferred gain	\$5	
		Equity		\$5
Fair value	\$100			
Sale price	\$105			
Carrying amount	\$ 95			
<b>Deferred gain</b>	<b>\$ 10</b>			
			<i>Debit</i>	<i>Credit</i>
		Deferred gain	\$10	
		Equity		\$5
		Financial liability		\$5
Fair value	\$100			
Sale price	\$105			
Carrying amount	\$100			
<b>Deferred gain</b>	<b>\$ 5</b>			

<b>Sale and operating leaseback transaction</b>		<b>Deferred gain/loss transition adjustment</b>		
			<i>Debit</i>	<i>Credit</i>
		Deferred gain	\$5	
		Financial liability		\$5
Fair value	\$100	Deferred gain written off to equity; no portion of the gain is attributable to off-market terms because the sale price < fair value.		
Sale price	\$ 95			
Carrying amount	\$ 90			
<b>Deferred gain</b>	<b>\$ 5</b>	Deferred gain	\$5	
		Equity		\$5
<b>Deferred loss scenarios</b>				
Fair value	\$100	Deferred loss recognized as an adjustment to the new leaseback ROU asset because the sale price < fair value (i.e. loss is attributable to off-market sale price).		
Sale price	\$ 95			
Carrying amount	\$100			
<b>Deferred loss</b>	<b>\$ 5</b>			
		ROU asset	\$5	
		Deferred loss		\$5
Fair value	\$100	Deferred loss recognized as an adjustment to the new leaseback ROU asset because the sale price < fair value (i.e. loss is attributable to off-market sale price).		
Sale price	\$ 80			
Carrying amount	\$ 95			
<b>Deferred loss</b>	<b>\$ 15</b>			
		ROU asset	\$15	
		Deferred loss		\$15
Fair value	\$100	Deferred loss recognized as an adjustment to the new leaseback ROU asset because the deferred loss is attributable to the sale price being less than fair value. \$5 of the total loss was recognized on the date of sale because the carrying amount > fair value by that amount.		
Sale price	\$ 80			
Carrying amount	\$105			
<b>Deferred loss</b>	<b>\$ 20</b>			
		ROU asset	\$20	
		Deferred loss		\$20
<b>No deferred gain/loss scenario</b>				
Fair value	\$100	N/A. There is no deferred gain or loss. The \$5 difference between carrying amount and sale price was recognized at the date of sale under Topic 840 because the carrying amount of the asset > its fair value.		
Sale price	\$100			
Carrying amount	\$105			
<b>Deferred gain/loss</b>	<b>\$ 0</b>			

## 13A.8 Build-to-suit lease arrangements



### Excerpt from ASC 842-10

#### 65 Transition and Open Effective Date Information

##### General

> Transition Related to Accounting Standards Updates No. 2016-02, *Leases (Topic 842)*, No. 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*, No. 2018-10, *Codification Improvements to Topic 842, Leases*, No. 2018-11, *Leases (Topic 842): Targeted Improvements*, No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, 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*, No. 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*, No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*, No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*, and No. 2023-01, *Leases (Topic 842): Common Control Arrangements*

**65-1** The following represents the transition and effective date information related to Accounting Standards Updates No. 2016-02, *Leases (Topic 842)*, No. 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*, No. 2018-10, *Codification Improvements to Topic 842, Leases*, No. 2018-11, *Leases (Topic 842): Targeted Improvements*, No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, 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*, No. 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*, No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*, No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*, and No. 2023-01, *Leases (Topic 842): Common Control Arrangements*: [Note: See paragraph 842-10-S65-1 for an SEC Staff Announcement on transition related to Update 2016-02.]

##### Build-to-suit lease arrangements

- 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.

### 13A.8.1 Derecognition of build-to-suit assets and liabilities

13A.8.10 The transition guidance in Topic 842 requires lessees to derecognize any assets (e.g. property, plant and equipment or construction-in-progress) and liabilities recorded solely as a result of being the accounting owner of a construction project under Topic 840 unless both: [842-10-65-1(u)]

- construction of the asset is in progress at the effective date of Topic 842; and
- the lessee is the accounting owner of the underlying asset under construction based on Topic 842 (see section 9.4).

13A.8.20 A lessee derecognizes existing build-to-suit assets and liabilities that are recorded solely as a result of being the accounting owner of the construction project under Topic 840 at the effective date. Any difference between the assets and liabilities derecognized is recorded in equity on that date – subject to the discussion in Question 13A.8.20 for lessee-paid costs. [842-10-65-1(u)(1)(ii), 65-1(u)(1)(iii)]

13A.8.30 [Not used]



### Question 13A.8.10

#### **Lease classification for build-to-suit leases in transition**

#### **On transition, how is lease classification assessed when the lessee was considered the owner of the asset under construction under the Topic 840 build-to-suit requirements?**

**Background:** For the purpose of this question, Lessee LE was deemed the accounting owner of an asset under construction in a build-to-suit lease arrangement under Topic 840. The lease inception date was January 1, 2016. The lease commencement date (i.e. the end of the construction period) was January 1, 2018. In accordance with paragraph 13A.8.20, the lessee derecognizes the underlying asset (see Question 13A.8.20) and related financial liability as of the effective date.

Two scenarios are discussed in this question.

1. There was a successful sale-leaseback under Topic 840 at January 1, 2018 (or any later date before January 1, 2019).
2. The lessee had a failed sale-leaseback at January 1, 2018 and continues to recognize the constructed asset and a financial liability at the effective date of Topic 842 (e.g. January 1, 2019).

**Interpretive response:** If the package of transition practical expedients is not elected, classification of the lease in either background scenario will be assessed as of the lease commencement date (January 1, 2018). This is consistent with the date any other lease is assessed for classification when the package of practical expedients is not elected (see Question 13A.2.20).

In contrast, if the package of transition practical expedients is elected, the answer is more complex.

- In Scenario 1, a lease exists under Topic 840 before the effective date, the classification of which would have been assessed as of lease inception under Topic 840. Because the package of practical expedients was elected, we do not believe the lessee should reassess the lease classification that was determined at lease inception.
- In Scenario 2, in the absence of specific guidance in Topic 842, we believe it would be acceptable for the lessee to assess classification of the lease as of either:
  - the commencement date of January 1, 2018, using the lease classification guidance in Topic 842; or
  - the inception date of January 1, 2016, using the lease classification guidance in Topic 840.

We believe the first approach is acceptable, even though the package of practical expedients has been elected, because there was no 'existing lease' that had previously been classified under Topic 840. We believe the second approach is acceptable because election of the package of transition practical expedients effectively grandfathered the legacy Topic 840 classification guidance, which required lease classification to be assessed

as of lease inception. We believe the chosen approach should be applied consistently to all similar circumstances.



### Question 13A.8.20

#### **Lessee-paid costs included in existing build-to-suit assets**

#### **If the carrying amount of a build-to-suit asset includes lessee-paid costs, should those amounts be written off at the effective date?**

**Background:** For purposes of this question, the lessee was considered to be the owner of the construction project under Topic 840; as a result, it has recognized assets and liabilities associated with the construction. The transition provisions of Topic 842 require the lessee to remove any assets and liabilities still recorded at the effective date solely as a result of being the accounting owner of the construction project under Topic 840 – unless the asset remains under construction at the effective date and the lessee is the accounting owner of the construction project under Topic 842 (see section 13A.8.4).

Assume the lessee paid the lessor or a third party amounts during the construction period that, apart from being considered the owner of the construction project, would have been recognized by the lessee as an asset. For example, the carrying amount of the build-to-suit asset may include amounts paid by the lessee for:

- construction of the lessor's owned asset or for lessor-owned leasehold improvements; and/or
- lessee-owned leasehold or property improvements.

Question 5.4.80 addresses determining the accounting owner of leasehold improvements.

**Interpretive response:** It depends on what the accounting for the payments would have been until the effective date absent the previous build-to-suit conclusion under Topic 840 that the lessee was the accounting owner of the construction project.

The lessee starts by determining the appropriate lease classification (see Question 13A.8.10). Next, the lessee determines:

- what the appropriate accounting treatment for those costs would have been at the time the costs were incurred; and
- the subsequent accounting for those costs between the date they were incurred and the effective date.

Key considerations generally include whether the amounts paid by the lessee are 'lease payments,' or instead are payments for lessee-owned leasehold or property improvements.

## **Operating lease classification**

### **Lessor was accounting owner**

If the *lessor* was the accounting owner of the underlying asset or of a leasehold or property improvement paid for by the lessee under an operating lease, amounts paid by the lessee to construct the lessor-owned asset or lessor-owned improvement would have been accounted for as part of the 'minimum lease payments' under Topic 840.

For example, if the lessee paid \$100,000 of the costs to construct the lessor-owned underlying asset during the construction period, absent the build-to-suit accounting, that amount would have been accounted for as a lease prepayment. Therefore, when accounting for the lease in transition, the lessee determines how much of the prepayment that would have existed absent the build-to-suit accounting would be unamortized at the effective date. The lessee then accounts for the unamortized prepayment based on the Topic 842 lessee transition requirements (see paragraph 13A.3.50).

### **Lessee was accounting owner**

If the *lessee* was the accounting owner of leasehold or property improvements, absent build-to-suit accounting, the lessee would have recognized the leasehold or property improvements as separate items of property, plant and equipment. The lessee would have amortized the cost of the improvements over the shorter of the (1) non-cancellable period of the lease plus renewal periods reasonably assured to be exercised or (2) useful life of the improvements. Therefore, at the effective date, the lessee should continue to recognize PP&E with a carrying amount equal to what the unamortized carrying amount of the improvements would have been had Topic 840 build-to-suit accounting never applied.

For example, assume the lessee paid \$100,000 for leasehold improvements for which it was the accounting owner. The lessee recognized those costs as part of the cost of the building and was depreciating them over the 30-year useful life of the building. Absent build-to-suit accounting, the amortization period for the leasehold improvements may have been considerably shorter – e.g. if the non-cancellable period of the lease was 15 years and the lessee was not reasonably assured of exercising an option to extend the lease. In that circumstance, the amount that should remain recognized at the effective date is the amount that would be unamortized had the amortization period of the leasehold improvements always been 15 years.

## **Capital/finance lease classification**

Absent the build-to-suit accounting, payments to a third party for leasehold or property improvements, or to the lessor before lease commencement, including during the construction period, may have been capitalized as part of the cost of the capital lease asset.

Under Topic 842, the carrying amount of the capital lease asset immediately before the effective date becomes the carrying amount of the new finance lease ROU asset in transition (see paragraph 13A.3.100). Therefore, at the Topic 842 effective date, the lessee would capitalize the remaining unamortized amount of these costs (previously included in property, plant and equipment under Topic 840) into the new finance lease ROU asset.

## 13A.8.2 Evaluating previous build-to-suit conclusions

13A.8.40 A lessee is not required to reevaluate whether it would have been the accounting owner of an asset under construction in accordance with Topic 842 unless construction of the asset is in progress at the effective date. This is regardless of whether the lessee was the accounting owner of the asset under Topic 840. [842-10-65-1(u)]

13A.8.50 If a lessee is determined to be the accounting owner of an asset under construction as of the effective date for which it was *not* the accounting owner under Topic 840, it will recognize the assets and liabilities arising from being the accounting owner of an asset under construction at the effective date. The lessee will account for the assets after the effective date using the Topic 842 sale-leaseback guidance.



### Observation

#### Build-to-suit transition

##### Control guidance applies only on or after the effective date

13A.8.60 The changes to the sale-leaseback guidance in Topic 842 will make it easier for a lessee that is the accounting owner of an asset under construction to derecognize the underlying asset at the end of the construction period.

13A.8.70 We believe the Board did not intend for a lessee to look back to periods before the effective date of Topic 842 to determine whether it would have been the accounting owner of an asset under construction. This intention would be inconsistent with much of the Board's rationale for its transition approach. It would also appear to be at odds with the guidance on sale-leaseback transactions that says the lessee does not reconsider whether a successful sale that occurred before the effective date would have also been successful under Topic 842.

13A.8.80 Instead, Topic 842 requires that the lessee consider whether it is the owner of an asset under construction only if construction is ongoing at the effective date.

##### **Topic 842 does not appear to prohibit reevaluation of ownership if the lessee was not the accounting owner under Topic 840**

13A.8.90 The transition guidance for existing build-to-suit assets and liabilities appears to preclude continued recognition of build-to-suit assets and liabilities on the balance sheet when construction is complete by the effective date, even if the lessee would have been the accounting owner of the underlying asset under Topic 842.

13A.8.100 However, because the transition guidance is silent, we believe it does not prohibit a lessee from evaluating under Topic 842 whether it was the accounting owner of an asset for which construction was complete by the effective date and for which it was *not* the accounting owner under Topic 840.

13A.8.110 We expect it to be rare that a lessee would choose to voluntarily make this evaluation. However, if it does, it should recognize the assets and liabilities arising from being the accounting owner of an asset under

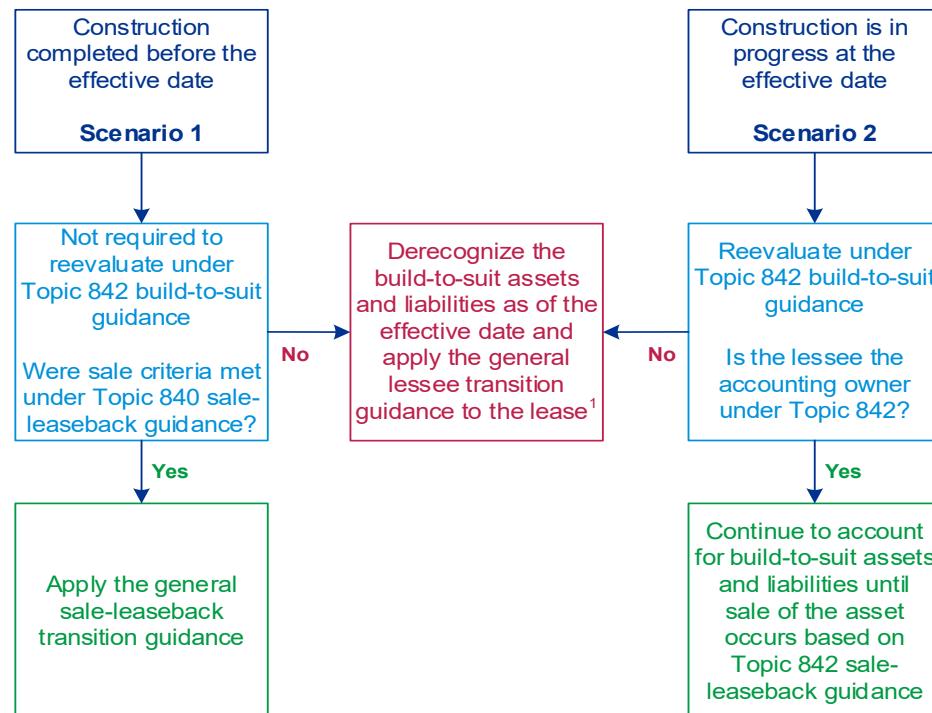
construction at the effective date if a sale would not have occurred before then under the Topic 842 sale-leaseback guidance (Topic 842, rather than Topic 840, because the lessee is applying Topic 842 in concluding it was the accounting owner of the asset under construction). In that case, the lessee will account for the transaction from the effective date using the Topic 842 sale-leaseback guidance. In contrast, if a sale would have occurred under Topic 842 before the effective date, the lessee should only account for the lease from the effective date.

### 13A.8.3 Build-to-suit arrangements accounted for as successful sale-leaseback transactions

13A.8.120 If the construction period ended before the effective date, and the transaction qualified for sale-leaseback accounting under Topic 840 before that date, the lessee only accounts for a lease at the effective date because the build-to-suit assets and liabilities would already have been derecognized before that date. The lessee applies the transition requirements in the same manner as it does for other sale-leaseback transactions on transition. For further discussion of the sale-leaseback transition provisions of Topic 842, see section 13A.7.  
[842-10-65-1(u)(2)]

### 13A.8.4 Lessee was the accounting owner under Topic 840

13A.8.130 The following diagram summarizes the transition requirements for a number of potential build-to-suit transition scenarios when the lessee was the accounting owner under Topic 840.



Note:

1. See section 13A.3 for discussion of the lessee transition provisions of Topic 842.

### ***Scenario 1: Construction completed before the effective date***

13A.8.140 The lessee does not evaluate whether it would have been the accounting owner of the asset under Topic 842 because construction was completed before the effective date. The lessee's transition accounting will depend on whether the Topic 840 sale criteria for a sale-leaseback transaction were met.

13A.8.150 When the Topic 840 sale criteria for a sale-leaseback transaction were met before the effective date, the lessee does not reevaluate that conclusion, and applies the Topic 842 transition guidance to the sale-leaseback.

13A.8.160 When the construction period ended before the effective date, but the Topic 840 sale criteria for a sale-leaseback transaction were not met, the lessee derecognizes the build-to-suit assets and liabilities that were recognized under Topic 840 as of the effective date. Any difference is recorded as an adjustment to equity at that date (after consideration of the guidance in Question 13A.8.20). The lessee then applies the general lessee transition guidance to the lease.

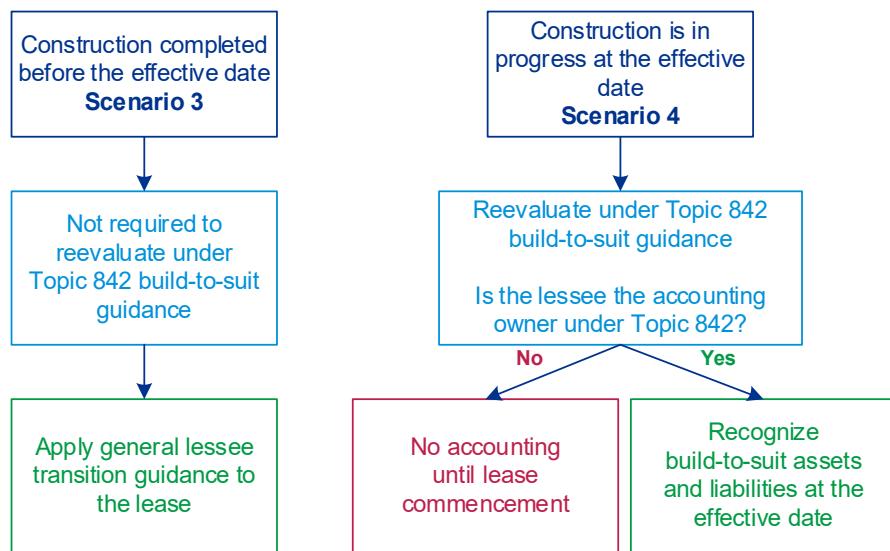
### ***Scenario 2: Construction is in progress at the effective date***

13A.8.170 The lessee reevaluates whether it is the accounting owner of the asset under Topic 842 at the effective date. If it is considered the accounting owner, the lessee continues to recognize the construction-in-progress assets and liabilities that arose because the lessee is the accounting owner until they qualify for derecognition under the sale-leaseback requirements of Topic 842.

13A.8.180 If the lessee is not considered the accounting owner, it derecognizes the build-to-suit assets and liabilities that it recognized under Topic 840 as of the effective date. The lessee records the difference as an adjustment to equity at that date (after consideration of the guidance in Question 13A.8.20). The lessee then applies the general lessee transition guidance to the lease.

## **13A.8.5 Lessee was not the accounting owner under Topic 840**

13A.8.190 The following diagram summarizes our understanding of the transition requirements for potential build-to-suit transition scenarios when the lessee was not the accounting owner under Topic 840.



### **Scenario 3: Construction completed before the effective date**

13A.8.200 The lessee is not required to evaluate whether it would have been the accounting owner of the asset while it was under construction in accordance with Topic 842. However, we do not believe the transition guidance prohibits a lessee from making this evaluation (see paragraph 13A.8.110).

13A.8.210 If the lessee does not undertake this evaluation, it applies the general lessee transition requirements to the lease.

13A.8.220 In the unlikely event that the lessee chooses to evaluate whether it would have been the accounting owner under Topic 842, it should follow the guidance in paragraph 13A.8.110.

### **Scenario 4: Construction is in progress at the effective date**

13A.8.230 The lessee evaluates whether it controls, at the effective date of Topic 842, an underlying asset a developer is presently constructing or designing that it will subsequently lease. If it controls the underlying asset, it will be the accounting owner under Topic 842.

13A.8.240 The lessee recognizes the assets and liabilities resulting from the conclusion that it is the accounting owner of the asset under construction at the effective date. The lessee will account for the transaction in accordance with the sale-leaseback guidance in Topic 842 from the effective date.

13A.8.250 If the lessee was not the accounting owner of the asset under either Topic 840 or Topic 842, then the lessee applies the requirements of Topic 842 at lease commencement.



## Observation

### **Lessees with build-to-suit leases may early adopt**

13A.8.260 In many cases, the transition provisions in Topic 842 permit (or require) lessees to derecognize build-to-suit assets and liabilities that were previously recognized under Topic 840, including such assets and liabilities that remained recognized because of the Topic 840 sale-leaseback requirements.

13A.8.270 In addition, the changes to the sale-leaseback guidance in Topic 842 make it easier for many lessees to derecognize build-to-suit assets and liabilities at the end of the construction period. Fewer build-to-suit arrangements for which a lessee is determined to be the accounting owner will result in failed sales.

13A.8.280 Therefore, some lessees for which these factors are relevant may early adopt Topic 842.

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## Observation

### **SAB Topic 11.M disclosure of impact on future periods**

13A.8.290 SEC registrants are required to evaluate new accounting standards that they have not yet adopted and to disclose their potential material effects. These disclosures generally should include a discussion about the effect that adoption is expected to have on the financial statements, unless this is not known or reasonably estimable. [\[SAB Topic 11.M\]](#)

13A.8.300 As discussed in paragraph 13A.8.10, on transition a lessee may derecognize significant property, plant and equipment and debt obligations that originally arose from build-to-suit lease arrangements. In their place, the lessee may recognize ROU assets and lease liabilities for the lease of the constructed assets.

13A.8.310 If this is the case for a lessee, among other disclosures it should likely provide in accordance with [SAB Topic 11.M](#), it should disclose these facts and provide a quantification of the related amounts. If precise quantification of the amounts is not yet practicable, a range may be provided. We believe the SEC generally expects that a lessee will refine its estimates (i.e. narrow the ranges previously provided) as the effective date approaches, and that it will not be acceptable for an entity to provide 'boilerplate' disclosures while only stating that it is continuing to evaluate the effect of Topic 842.

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## 13A.9 Previous business combinations



### Excerpt from ASC 842-10

#### 65 Transition and Open Effective Date Information

##### General

> Transition Related to Accounting Standards Updates No. 2016-02, *Leases (Topic 842)*, No. 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*, No. 2018-10, *Codification Improvements to Topic 842, Leases*, No. 2018-11, *Leases (Topic 842): Targeted Improvements*, No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, 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*, No. 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*, No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*, No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*, and No. 2023-01, *Leases (Topic 842): Common Control Arrangements*

**65-1** The following represents the transition and effective date information related to Accounting Standards Updates No. 2016-02, *Leases (Topic 842)*, No. 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*, No. 2018-10, *Codification Improvements to Topic 842, Leases*, No. 2018-11, *Leases (Topic 842): Targeted Improvements*, No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, 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*, No. 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*, No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*, No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*, and No. 2023-01, *Leases (Topic 842): Common Control Arrangements*: [Note: See paragraph 842-10-S65-1 for an SEC Staff Announcement on transition related to Update 2016-02.]

##### Amounts previously recognized in respect of business combinations

- 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).

13A.9.10 If an entity previously recognized an asset (liability) relating to favorable (unfavorable) terms of an operating lease acquired as part of a business combination: [842-10-65-1(h)]

- a **lessee** derecognizes that asset (liability), and adjusts the carrying amount of the ROU asset recognized on transition by a corresponding amount.
- a **lessor** derecognizes that asset (liability) only if it arises from a sales-type or direct financing lease, and makes a corresponding adjustment to equity. The lessor should also consider section 13A.4.2 for transition guidance when the lease classification changes.

13A.9.20 A favorable lease asset or unfavorable lease liability associated with an operating lease is not written off in transition by lessors. Lessors will continue to recognize such favorable lease assets or unfavorable lease liabilities even after the adoption of the amendments to Topic 805 (business combinations) included in ASU 2016-02; for a discussion about leases acquired in a business combination or asset acquisition, see chapter 11. [842-10-65-1(h)(1)]



### Observation

#### **Impact of previously recognized favorable lease asset or unfavorable lease liability on lessee's subsequent accounting**

13A.9.30 Topic 842 does not prescribe or illustrate the subsequent accounting for a lease of a lessee that, at the effective date, is affected by a previously recognized favorable lease asset or unfavorable lease liability, other than to say that the asset or liability is written off as an adjustment to the effective date ROU asset. However, we believe that:

- a favorable lease asset would affect the accounting for the lease on and after the effective date in the same manner as initial direct costs – i.e. it would increase the lessee's ROU asset recognized at the effective date; and
- an unfavorable lease liability would affect the accounting for the lease after the effective date in the same manner as a lease incentive – i.e. it would decrease the lessee's ROU asset recognized at the effective date.



### Question 13A.9.10

#### **(Un)favorable contract (liabilities) assets for contracts not accounted for as leases under Topic 840**

##### **How should a lessee account for a favorable (unfavorable) contract asset (liability) when a non-lease contract is reassessed as a lease on transition to Topic 842?**

**Background:** Assume that Company AR acquired Company AE before either entity adopted Topic 842. As part of AR's acquisition accounting, it recorded either a favorable contract intangible asset or an unfavorable contract liability for an existing service contract for which AE was the customer and had appropriately determined the contract was not a lease under Topic 840.

At adoption, AR does not elect the transition package of practical expedients (see section 13A.2), and therefore reassesses the AE contract against the Topic 842 lease definition. Based thereon, the AE contract meets the definition of a lease.

In this situation, the question arises about how to account for the remaining favorable contract intangible asset or unfavorable contract liability at adoption, noting that lessees no longer recognize either for leases after the adoption of Topic 842 (see paragraph 11.1.10), and at adoption derecognize any such assets or liabilities for existing operating leases as an adjustment to the new ROU asset.

**Interpretive response:** We believe the lessee should derecognize the existing contract asset (liability) at the adoption date, with a corresponding adjustment to the ROU asset.

# 13B. Effective dates and transition: comparative method

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### **How the standard works**

#### **13B.1 Effective dates**

##### **Questions**

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- 13B.1.20 [Not used]
- 13B.1.30 Issuance of a registration statement on Form S-3 after the effective date
- 13B.1.40 Effects of adoption of Topic 842 by a successor entity on predecessor periods
- 13B.1.50 Effective date for certain public business entities
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#### **13B.2 Transition principles – lessees and lessors**

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- 13B.2.10 Applying hindsight with lease remeasurements and modifications

### **13B.3 Transition for lessees**

- 13B.3.1 Lessee elects package of practical expedients
- 13B.3.2 Lessee does not elect package of practical expedients
- 13B.3.3 ASU 2021-09, Discount Rate for Lessees That Are Not Public Business Entities
- 13B.3.4 ASU 2023-01, Common Control Arrangements

### **Observation**

Changes in lessee lease classification in transition

### **Questions**

- 13B.3.10 Minimum rental payments
- 13B.3.20 Excluding CAM costs
- 13B.3.30 Measurement of lease payments that depend on an index or rate in determining the operating lease liability
- 13B.3.40 Foreign exchange rate to use in transition when the lease is not denominated in the entity's functional currency
- 13B.3.50 Determining the incremental borrowing rate in transition
- 13B.3.60 ROU asset abandoned before the date of initial application
- 13B.3.70 Executory costs that are part of Topic 420 liabilities on transition
- 13B.3.80 Transition guidance for Topic 420 liabilities results in negative ROU asset carrying amount

- 13B.3.90 Existing sublease liabilities under Topic 840
- 13B.3.100 Accounting for foreign currency gains/losses during transition
- 13B.3.110 Effects of Topic 360 impairments before the effective date
- 13B.3.120 Transition impact on prior asset group impairments
- 13B.3.130 Recognizing 'hidden' ROU asset impairments on transition
- 13B.3.140 Amortization period for leasehold improvements previously acquired in a business combination

### **Examples**

- 13B.3.10 Lessee transition for an existing operating lease with package of practical expedients elected – Approach A in Question 13B.3.10
- 13B.3.20 Lessee transition for an existing operating lease with package of practical expedients elected – Approach B in Question 13B.3.10
- 13B.3.30 Lessee transition for an existing capital lease with package of practical expedients elected
- 13B.3.40 Lessee transition for operating lease under Topic 840 classified as a finance lease under Topic 842 – package of practical expedients not elected

### **13B.4 Transition for lessors**

- 13B.4.1 Lessor elects package of practical expedients
- 13B.4.2 Lessor does not elect package of practical expedients
- 13B.4.3 ASU 2018-20, Narrow-Scope Improvements for Lessors
- 13B.4.4 ASU 2019-01, Codification Improvements
- 13B.4.5 ASU 2021-05, Lessors—Certain Leases with Variable Lease Payments
- 13B.4.6 ASU 2023-01, Common Control Arrangements

### **Observations**

Changes in lessor lease classification in transition

Initial direct costs included in the net investment in a sales-type or direct financing lease

### **Questions**

- 13B.4.10 Offset to assets and liabilities written-off on transition
- 13B.4.20 Revenue recognition guidance for arrangements that no longer meet the definition of a lease

### **Example**

- 13B.4.10 Lessor transition for an operating lease under Topic 840 classified as a sales-type lease under Topic 842

## 13B.5 Applying the guidance on components of a contract in transition

- 13B.5.1 Lessee guidance
- 13B.5.2 Lessor guidance – practical expedient for separation of lease and non-lease components does not apply
- 13B.5.3 Lessor guidance – practical expedient for separation of lease and non-lease components applies

### Observation

Lessor reallocation may be permissible in some cases

### Questions

- 13B.5.10 Not separating lease from non-lease components for existing leases on transition
- 13B.5.20 Accounting policy implications of separating lease from non-lease components for existing leases on transition
- 13B.5.30 Topic 842 and Topic 606 interaction in accounting for CAM
- 13B.5.40 Existing arrangements with lease and non-lease elements – substantial services

## 13B.6 Leveraged leases

### Question

- 13B.6.10 Acquired leveraged leases

## 13B.7 Sale-leaseback transactions

### Questions

- 13B.7.10 Leaseback accounting on transition for previously failed sales
- 13B.7.20 Successful sale-leaseback transactions that include seller-lessee repurchase options on adoption of Topic 606

### Examples

- 13B.7.10 Sale-leaseback transaction previously accounted for as a sale and an operating leaseback under Topic 840
- 13B.7.20 Sale-leaseback deferred gains and losses in transition

## 13B.8 Build-to-suit lease arrangements

- 13B.8.1 Derecognition of build-to-suit assets and liabilities
- 13B.8.2 Evaluating previous build-to-suit conclusions
- 13B.8.3 Build-to-suit arrangements accounted for as successful sale-leaseback transactions
- 13B.8.4 Lessee was the accounting owner under Topic 840
- 13B.8.5 Lessee was not the accounting owner under Topic 840

**Observations**

Build-to-suit transition

Lessees with build-to-suit leases may early adopt

SAB Topic 11.M disclosure of impact on future periods

**Questions**

13B.8.10 Lease classification for build-to-suit leases on transition

13B.8.20 Lessee-paid costs included in existing build-to-suit assets

**13B.9 Previous business combinations****Observation**

Impact of previously recognized favorable lease asset or unfavorable lease liability on lessee's subsequent accounting

**Question**

13B.9.10 (Un)favorable contract (liabilities) assets for contracts not accounted for as leases under Topic 840

## Structure of transition chapters

The discussion of transition has been divided into two separate chapters.

- This chapter discusses the 'comparative method', which is the original transition method in ASU 2016-02.
- Chapter 13A discusses the 'effective date method', which is the additional transition method introduced by ASU 2018-11.

For purposes of comparison, the Question numbers are the same in each of these transition chapters. If a question is not applicable to one chapter, that question is indicated as 'Not used' in the 'Detailed contents.'

The guidance that follows in this chapter should be used only by those who elect the comparative method.

## How the standard works

Topic 842 requires entities to use a modified retrospective transition method. Entities that use the comparative method record the cumulative-effect adjustment to the opening balance of retained earnings as of the beginning of the earliest comparative period presented in the financial statements. From that date to the effective date, an entity applies the Topic 842 transition guidance to new and existing leases.

<b>Effective date:</b>	Public business entities: <sup>1</sup> Annual and interim periods in fiscal years beginning after December 15, 2018.	Public not-for-profit entities: <sup>2,3</sup> Annual and interim periods in fiscal years beginning after December 15, 2019.	Other entities: <ul style="list-style-type: none"> <li>— Annual periods in fiscal years beginning after December 15, 2021.</li> <li>— Interim periods in fiscal years beginning after December 15, 2022.</li> </ul>
<b>Date of initial application:</b>	The beginning of the earliest period presented in the entity's first annual financial statements in which Topic 842 is applied. For a public business entity with a calendar year-end that does not early adopt Topic 842, this date will be January 1, 2017. For a private company with a calendar year-end that does not early adopt Topic 842 and presents one year of historical information, this date will be January 1, 2021.		
<b>Early adoption:</b>	All entities can adopt Topic 842 immediately.		
<b>Transition method:</b>	Modified retrospective, with application of the new guidance to all periods presented in the financial statements.		
<b>Transition date:</b>	As referred to in this chapter, the date on which an entity applies the transition requirements to a lease that commences before the effective date or early adoption date, which is the later of: (1) the beginning of the earliest period presented in the financial statements in which Topic 842 is initially applied, or (2) the 'commencement date' for the lease (see section 5.1).		
<b>Package of practical expedients (all or nothing):</b>	An entity may elect not to reassess: <ul style="list-style-type: none"> <li>— whether expired or existing contracts contain leases under the new definition of a lease;</li> <li>— lease classification for expired or existing leases; and</li> <li>— whether previously capitalized initial direct costs would qualify for capitalization under Topic 842.</li> </ul>		
<b>Use of hindsight:</b>	<ul style="list-style-type: none"> <li>— Hindsight allowed when considering the likelihood that lessee options to extend or terminate a lease or purchase the underlying asset will be exercised.</li> <li>— Elect on its own or with the package of practical expedients.</li> </ul>		
<b>Land easements:</b>	<ul style="list-style-type: none"> <li>— May elect not to assess at transition whether any expired or existing land easements are, or contain, leases if they were not previously accounted for as leases under Topic 840.</li> <li>— Elect on its own or with the package of practical expedients and/or hindsight.</li> </ul>		

**Notes:**

1. This includes (1) public business entities, (2) public not-for-profit entities not addressed by Note 3, and (3) employee benefit plans that file or furnish financial statements with or to the SEC.
2. 'Public' not-for-profit entities are those that have issued or are conduit bond obligors for securities that are traded, listed or quoted on an exchange or an over-the-counter market.
3. Public not-for-profit entities are eligible to elect this effective date if they did not issue GAAP-compliant financial statements reflecting the adoption of Topic 842 before June 3, 2020 (the issuance date of ASU 2020-05).

## 13B.1 Effective dates



### Excerpt from ASC 842-10

#### 65 Transition and Open Effective Date Information

##### General

> Transition Related to Accounting Standards Updates No. 2016-02, *Leases (Topic 842)*, No. 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*, No. 2018-10, *Codification Improvements to Topic 842, Leases*, No. 2018-11, *Leases (Topic 842): Targeted Improvements*, No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, 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*, No. 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*, No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*, No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*, and No. 2023-01, *Leases (Topic 842): Common Control Arrangements*

**65-1** The following represents the transition and effective date information related to Accounting Standards Updates No. 2016-02, *Leases (Topic 842)*, No. 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*, No. 2018-10, *Codification Improvements to Topic 842, Leases*, No. 2018-11, *Leases (Topic 842): Targeted Improvements*, No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, 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*, No. 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*, No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*, No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*, and No. 2023-01, *Leases (Topic 842): Common Control Arrangements*: [Note: See paragraph 842-10-S65-1 for an SEC Staff Announcement on transition related to Update 2016-02.]

- 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.

> Transition Related to Accounting Standards Update No. 2018-11, *Leases (Topic 842): Targeted Improvements*

**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.

> Transition Related to Accounting Standards Update No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*

**65-3** 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*:

- 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 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 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:

1. In the first reporting period ending after the issuance of the pending content that links to this paragraph
2. In the first reporting period beginning after the issuance of the pending content that links to this paragraph.
- 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:
  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.

> Transition 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*

**65-4** 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. Early 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).

> Transition Related to Accounting Standards Update No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*

**65-5** The following represents the transition and effective date information related to Accounting Standards Update No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*:

- a. An entity that has not yet adopted the pending content that links to paragraph 842-10-65-1 as of July 19, 2021, shall apply the pending content that links to this paragraph when it 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 within the scope of paragraph 842-10-65-1(a) that has adopted the pending content that links to paragraph 842-10-65-1 as of July 19, 2021, shall apply the pending content that links to this paragraph for fiscal years beginning after December 15, 2021, and interim periods within those fiscal years. Earlier application is permitted.
- c. An entity within the scope of paragraph 842-10-65-1(b) that has adopted the pending content that links to paragraph 842-10-65-1 as of July 19, 2021, shall apply the pending content that links to this paragraph for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. Earlier application is permitted.
- d. An entity within the scope of (b) or (c) shall apply the pending content that links to this paragraph by using one of the following two methods:
  1. Retrospectively to the date in which the pending content that links to paragraph 842-10-65-1 was adopted (the beginning of the period of adoption of Topic 842). Under this transition method, the entity shall apply the pending content that links to this paragraph to leases that commence or are modified on or after the beginning of the period of its adoption of Topic 842 and do not meet the conditions in paragraph 842-10-25-8.
  2. Prospectively to leases that commence or are modified on or after the date that the entity first applies the pending content that links to this paragraph and do not meet the conditions in paragraphs 842-10-25-8.
- e. An entity within the scope of (b) or (c) that elects the transition method in (d)(1) shall provide the following transition disclosures:
  1. The applicable 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
  2. The transition disclosures in paragraph 250-10-50-1(b)(3) as of the beginning of the earliest period presented but not before the date in which the pending content that links to paragraph 842-10-65-1 was adopted.
- f. An entity within the scope of (b) or (c) that elects the transition method in (d)(2) shall provide the following transition disclosures:
  1. The nature of and reason for the change in accounting principle
  2. The transition method
  3. A qualitative description of the financial statement line items affected by the change.

> Transition Related to Accounting Standards Update No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*

**65-6** The following represents the transition and effective date information related to Accounting Standards Update No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*:

- a. An entity that has not yet adopted the pending content that links to paragraph 842-10-65-1 as of 11/11/2021 shall apply the pending content that links to this paragraph to all new and existing leases when the entity first applies the pending content that links to paragraph 842-10-65-1. That entity 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 (as of 11/11/2021) shall:
  1. 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 as of the beginning of the fiscal year of adoption.
  2. Apply the pending content that links to this paragraph on a modified retrospective basis to leases affected by the amendments existing as of the beginning of the fiscal year of adoption by adjusting the lease liability, which shall be calculated based on the discount rate and remaining lease term at the beginning of the fiscal year of adoption. An entity shall recognize the amount of the change in the lease liability as an adjustment to the corresponding right-of-use asset, unless:
    - i. The carrying amount of the right-of-use asset is reduced to zero, in which case the entity shall recognize any remaining amount of the adjustment to opening retained earnings at the beginning of the fiscal year of adoption.
    - ii. The adjustment would increase a right-of-use asset that was previously impaired, in which case the entity shall record the adjustment to opening retained earnings at the beginning of the fiscal year of adoption.
- c. An entity within the scope of (b) shall not treat the adoption of the pending content that links to this paragraph as an event that would require the entity to:
  1. Remeasure and reallocate the consideration in the contract in accordance with paragraph 842-10-15-36.
  2. Reassess the lease term or a lessee option to purchase the underlying asset in accordance with paragraph 842-10-35-1.
  3. Remeasure the lease payments in accordance with paragraph 842-10-35-4.
  4. Reassess lease classification in accordance with paragraph 842-10-25-1.
- d. An entity within the scope of (b) that has adopted the pending content that links to this paragraph shall disclose the following as of the beginning of the fiscal year of adoption (rather than at the beginning of the earliest period presented):

1. The information required by paragraph 250-10-50-1(a) and (b)(3), if applicable
2. The recognized amount of changes in lease liabilities and corresponding right-of-use assets resulting from the transition adjustment.

For an entity within the scope of (b), at the date of adoption of the pending content that links to this paragraph, the entity may choose to apply or discontinue using the risk-free rate for any class of underlying asset.

> Transition Related to Accounting Standards Update No. 2023-01, *Leases (Topic 842): Common Control Arrangements*

**65-7** The following represents the transition and effective date information related to the practical expedient in Accounting Standards Update No. 2023-01, *Leases (Topic 842): Common Control Arrangements*:

- a. The pending content that links to this paragraph shall be effective for fiscal years, including interim periods within those fiscal years, beginning after December 15, 2023. Early adoption is permitted in any annual or interim period for which financial statements have not yet been made available for issuance. If an entity adopts the pending content that links to this paragraph in an interim period, it shall adopt that pending content as of the beginning of the fiscal year that includes that interim period.
- b. An entity that adopts the pending content that links to this paragraph concurrently with adopting the pending content that links to paragraph 842-10-65-1 shall apply the pending content that links to this paragraph using the same transition method elected for the pending content that links to paragraph 842-10-65-1.
- c. An entity that adopted the pending content that links to paragraph 842-10-65-1 before adopting the pending content that links to this paragraph shall apply the pending content that links to this paragraph using either of the following two methods:
  1. Prospectively to arrangements that commence or are modified on or after the date that the entity first applies the pending content that links to this paragraph.
  2. Retrospectively to the beginning of the period in which the pending content that links to paragraph 842-10-65-1 was first applied. The pending content that links to this paragraph shall not be applicable for arrangements no longer in place at the date of adoption. Under this transition method:
    - i. If an arrangement previously considered to be a lease continues to be a lease after applying the pending content that links to this paragraph, an entity shall apply the requirements in paragraphs 842-10-25-9 through 25-17 to any changes in the lease resulting from application of the practical expedient in the pending content that links to this paragraph. Any amounts that otherwise would have been recognized in earnings shall be recognized as a cumulative-effect adjustment to opening retained earnings (or net assets of a not-for-profit entity) at the beginning of the earliest period presented in accordance with the pending content that links to paragraph 842-10-65-1.

- ii. If an arrangement previously not considered a lease becomes a lease after applying the pending content that links to this paragraph, an entity shall account for the arrangement as a new lease.
- d. An entity may document any existing unwritten terms and conditions of an arrangement between entities under common control before the date on which the entity's first interim (if applicable) or annual financial statements are available to be issued in accordance with the pending content that links to this paragraph.
- e. An entity within the scope of (c) shall provide the applicable transition disclosures required by Topic 250 on accounting changes and error corrections, except for the requirements in paragraphs 250-10-50-1(b)(2) and 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 earliest period presented but not before the date on which the pending content that links to paragraph 842-10-65-1 was adopted.
- f. An entity that elects the practical expedient(s) in paragraph 842-10-65-1(f) or (g) is not required to apply either of those practical expedients to common control arrangements for which the pending content that links to this paragraph is being applied.

> Transition Related to Accounting Standards Update No. 2023-01, *Leases (Topic 842): Common Control Arrangements*

**65-8** The following represents the transition and effective date information related to the accounting for leasehold improvements associated with leases between entities under common control in Accounting Standards Update No. 2023-01, *Leases (Topic 842): Common Control Arrangements*:

- a. The pending content that links to this paragraph shall be effective for fiscal years, including interim periods within those fiscal years, beginning after December 15, 2023. Early adoption is permitted in any annual or interim period for which financial statements have not yet been made available for issuance. If an entity adopts the pending content that links to this paragraph in an interim period, it shall adopt that pending content as of the beginning of the fiscal year that includes that interim period.
- b. An entity that adopts the pending content that links to this paragraph concurrently with adopting the pending content that links to paragraph 842-10-65-1 may apply the pending content that links to this paragraph using the same transition method elected for the pending content that links to paragraph 842-10-65-1 or may apply the pending content that links to this paragraph using either of the prospective methods specified in (c)(1) and (c)(2) below.
- c. An entity that adopted the pending content that links to paragraph 842-10-65-1 before adopting the pending content that links to this paragraph shall apply the pending content that links to this paragraph using one of the following methods:
  1. Prospectively to all new leasehold improvements recognized on or after the date that the entity first applies the pending content that links to this paragraph.
  2. Prospectively to all new and existing leasehold improvements recognized on or after the date that the entity first applies the pending

- content that links to this paragraph. An entity that elects this transition approach shall amortize the remaining balance of leasehold improvements existing at the date of adoption of the pending content that links to this paragraph over the remaining useful life of those improvements to the common control group determined at that date.
3. Retrospectively to the beginning of the period in which the pending content that links to paragraph 842-10-65-1 was first applied. Any leasehold improvements previously amortized or impaired that otherwise would not have been amortized or impaired had the pending content that links to this paragraph been applicable shall be recognized through a cumulative-effect adjustment to the opening balance of retained earnings (or net assets of a not-for-profit entity) at the beginning of the earliest period presented in accordance with the pending content that links to paragraph 842-10-65-1.
  - d. An entity within the scope of (c) shall provide the applicable transition disclosures required by Topic 250 on accounting changes and error corrections, except for the requirements in paragraphs 250-10-50-1(b)(2) and 250-10-50-3. An entity that elects the transition method in (c)(3) shall provide the transition disclosures in paragraph 250-10-50-1(b)(3) as of the beginning of the earliest period presented but not before the date on which the pending content that links to paragraph 842-10-65-1 was adopted.

> SEC Staff Guidance

- > SEC Staff Announcement: Transition Related to Accounting Standards Updates No. 2014-09 and 2016-02

**S65-1 Note:** At the December 2019 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff announced that it would not object to a public business entity that otherwise would not meet the definition of a public business entity except for a requirement to include or the inclusion of its financial statements or financial information in another entity's filing with the SEC adopting Topic 842, Leases, for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021. Those dates are consistent with the effective dates for Topic 842 as amended in Accounting Standards Update No. 2019-10, *Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates*. The following is the text of SEC Staff Announcement: Transition Related to Accounting Standards Updates No. 2014-09 and 2016-02.

FASB Accounting Standards Updates No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, issued in May 2014 and codified in ASC Topic 606, Revenue from Contracts with Customers, and No. 2016-02, *Leases (Topic 842)*, issued in February 2016 and codified in ASC Topic 842, Leases, provide effective dates that differ for (1) **public business entities** and certain other specified entities and (2) all other entities. The SEC staff has received inquiries from stakeholders regarding the application of the effective dates of ASC Topic 606 and ASC Topic 842 for a public business entity<sup>FN1</sup> that otherwise would not meet the definition of a public business entity except for a requirement to include or the inclusion of its financial statements or financial information in another entity's filing with the SEC.

The transition provisions in ASC Topic 606 require that a public business entity and certain other specified entities adopt ASC Topic 606 for annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period.<sup>FN2</sup> All other entities are required to adopt ASC Topic 606 for annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019.

The transition provisions in ASC Topic 842 require that a public business entity and certain other specified entities adopt ASC Topic 842 for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years.<sup>FN3</sup> All other entities are required to adopt ASC Topic 842 for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020.

In response to the stakeholder inquiries outlined above, the SEC staff would not object to a public business entity that otherwise would not meet the definition of a public business entity except for a requirement to include or the inclusion of its financial statements or financial information in another entity's filing with the SEC adopting (1) ASC Topic 606 for annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019, and (2) ASC Topic 842 for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020.

A public business entity that otherwise would not meet the definition of a public business entity except for a requirement to include or the inclusion of its financial statements or financial information in another entity's filing with the SEC may still elect to adopt ASC Topic 606 and ASC Topic 842 according to the public business entity effective dates outlined above.

This announcement is applicable only to public business entities that otherwise would not meet the definition of a public business entity except for a requirement to include or the inclusion of its financial statements or financial information in another entity's filing with the SEC. This announcement is not applicable to other public business entities.

FN 1 The definition of Public Business Entity in the FASB's ASC Master Glossary states, in part, the following:

A public business entity is a business entity meeting any one of the criteria below . . .

- 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) . . .

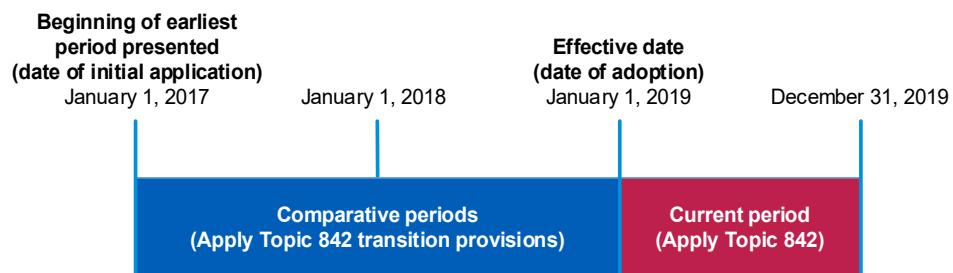
An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in

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.

FN 2 Early adoption of ASC Topic 606 is permitted for public business entities and certain other specified entities only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.

FN 3 Early adoption of ASC Topic 842 is permitted for public business entities and certain other specified entities, as well as for all other entities.

13B.1.10 If a calendar year-end public business entity adopts Topic 842 in accordance with the mandatory effective date, the following are the relevant dates. [842-10-65-1(a) – 65-1(d)]



13B.1.20 An entity can early adopt Topic 842 at any time after issuance. [842-10-65-1(a) – 65-1(b)]



## Question 13B.1.10 Early adoption considerations

### What reasons might an entity have to early adopt Topic 842?

#### Interpretive response:

#### Lessors may want to align implementation with Topic 606

Most of the changes applicable to lessors transitioning from Topic 840 to Topic 842 were designed to substantially align key aspects of the lessor accounting model with the new revenue recognition guidance in Topic 606. For example, the guidance covering separation and allocation guidance for lease and non-lease components, the lease modifications guidance, and the contract combinations guidance are aligned with Topic 606, and the guidance on initial direct costs is aligned with Subtopic 340-40 (other assets and deferred costs related to contracts with customers). [ASU 2016-02.BC8(d)]

Those aspects of Topic 606 (and Subtopic 340-40) and Topic 842 that are substantially aligned are designed to work together. The Board's decision to align these aspects of the guidance explicitly considered that many lessors have

contracts that contain lease and non-lease (e.g. services or supplies) components and that those lessors in particular would benefit from the alignment. Consequently, many lessors may find it preferable to early adopt Topic 842 at the same time as they adopt Topic 606.

#### **Entities may want to minimize disruption**

Most entities will likely be affected by the implementation of both Topic 606 and Topic 842. Some entities might view it as advantageous to adopt both Topics concurrently, in a big bang approach, to minimize the extent of ongoing systems and process changes, get past the disruption, and revert to a steady state accounting environment more quickly.

#### **Seller-lessees in real estate sale-leaseback transactions may want to early adopt**

As discussed in section 9.1, it will generally be easier to achieve sale accounting for real estate sale-leaseback transactions under Topic 842 than under Topic 840. A seller-lessee that has, or is contemplating, a significant real estate sale-leaseback transaction that is, or is expected to be, a failed sale under Topic 840 might want to early adopt Topic 842 if the transaction would be accounted for as a sale and a leaseback. For further discussion, see section 13B.7.

#### **Lessees with existing build-to-suit lease arrangements may want to early adopt**

Because of the existing build-to-suit lease accounting guidance in Topic 840, there are many lessees that have assets and liabilities recognized for assets that they do not legally own, but were deemed to own for accounting purposes during the construction period. In some of those cases, the construction period ended many years ago but, because of the restrictive sale-leaseback requirements applicable to real estate under Topic 840, the entity has been unable to derecognize those assets and liabilities. Because the transition provisions in Topic 842 applicable to build-to-suit leases and sale-leaseback transactions may permit the entity to derecognize those assets and liabilities (see section 13B.8), some entities in this situation may choose to early adopt Topic 842.



#### Question 13B.1.30

#### **Issuance of a registration statement on Form S-3 after the effective date**

**Does the reissuance of a registrant's financial statements in conjunction with filing a registration statement on Form S-3 change the date of initial application to January 1, 2016 because it is the beginning of the earliest comparative period presented?**

**Background:** A calendar year-end public entity adopts Topic 842 on January 1, 2019. The beginning of the earliest comparative period presented is January 1, 2017. In May 2019, the registrant files its first quarter 2019 Form 10-Q, which

reflects the adoption of Topic 842. Shortly after, the registrant files a registration statement on Form S-3 that includes financial statements for the years ending December 31, 2018, 2017 and 2016, as well as the quarters ending March 31, 2019 and 2018.

Item 11(b)(ii) of Form S-3 requires retrospective revision of the pre-event audited financial statements that were incorporated by reference in the Form S-3 to reflect a subsequent change in accounting principle.

**Interpretive response:** No. The reissuance of the financial statements in the Form S-3 accelerates the provision of the retroactively restated financial statements for the years ended December 31, 2018 and 2017, but it does not change the date of initial application from January 1, 2017 in the background example. [FRM 11210.1]



#### Question 13B.1.40

#### Effects of adoption of Topic 842 by a successor entity on predecessor periods

### Does a successor entity have to retrospectively adjust predecessor period financial statements on adoption of Topic 842?

**Background:** Comparative financial statements may include periods related to both a predecessor entity ('predecessor periods') and periods related to a successor entity ('successor periods') when there is change in the basis of accounting, such as resulting from a change in control, push-down accounting or fresh-start reporting. The successor entity's financial statement presentation often includes a double black line separating the predecessor and successor periods to communicate that the financial information between those periods is not comparable due to the different bases of accounting.

For example, assume Registrant acquires all of the outstanding stock of Subsidiary on September 30, 2018. Registrant accounts for the acquisition as a business combination under Topic 805 and Subsidiary applies push-down accounting so its separate financial statements reflect a change in accounting basis and are split between predecessor and successor periods. As a result, Subsidiary's December 31, 2018 income statement includes a 3-month successor period and a 9-month predecessor period separated by a black vertical line.

**Interpretive response:** No. The SEC staff concluded there is no US GAAP or other regulatory requirement to retrospectively adjust predecessor periods for accounting changes by a successor entity. Therefore, entities that adopt a new accounting standard (e.g. Topic 842) in one period (e.g. calendar year 2019) are not required to revise the predecessor period financial statements presented. This applies to both voluntary and involuntary adoptions of new accounting standards.

Continuing the example in the background, Registrant and Subsidiary adopt Topic 842 on January 1, 2019 using the comparative period transition approach. Subsidiary reflects the modified retrospective adoption of Topic 842

in the 3-month successor period ended December 31, 2018 but does not retrospectively adjust the 9-month predecessor period for the adoption. The notes to Subsidiary's 2019 financial statements will include relevant information for the predecessor and successor periods to explain the difference in basis as well as the impact of adopting Topic 842.



### Question 13B.1.50

#### **Effective date for certain public business entities**

**Does an entity that is considered a 'public business entity' solely because its financial statements or summarized financial information are included in an SEC filing have to follow the mandatory effective date for public business entities?**

**Interpretive response:** No. At the July 20, 2017 EITF meeting, the SEC Observer to the EITF announced that the SEC staff will not object if certain public business entities (PBEs) use the adoption dates for 'other entities'. The SEC announcement was later codified in paragraph 842-10-S65-1. [842-10-S65-1]

The SEC staff has confirmed its intent to continue to extend relief to those same PBEs based on the principles in paragraph 842-10-S65-1. This means that although paragraph 842-10-S65-1 references the 'other entities' mandatory effective date enacted by ASU 2019-10, PBEs eligible for the SEC staff relief can avail themselves of the additional one-year extension of that date afforded by ASU 2020-05. See 'How the standard works' in this chapter for effective date information. [CAQ SEC Regs Comm 07/2020, 842-10-S65-1]

The SEC staff's effective date relief is narrow and applies to an entity that otherwise would not meet the definition of a PBE, but does so *only* because its financial statements or summarized financial information is included in another entity's SEC filing.

Situations where the SEC staff's relief may apply include, but are not limited to:

- private company equity method investees;
- private acquired businesses;
- acquired real estate operations;
- properties securing loans that represent an asset concentration;
- significant lessees; and
- affiliates whose securities constitute a substantial portion of the collateral of a security that is registered or being registered with the SEC.

A private entity whose financial information is included in an SEC filing but also meets the definition of a PBE for other reasons – e.g. the filing of financial statements with a regulatory agency other than the SEC – is not eligible for the SEC's relief.



### Question 13B.1.60

#### **Effective date for an entity in the process of an initial public offering (IPO)**

#### **What is a non-EGC's Topic 842 adoption date when issuing financial statements to be included in an IPO registration statement?**

**Interpretive response:** An entity that is not an EGC uses the adoption date that would have applied to it had it been a public business entity (PBE) all along (e.g. January 1, 2019 if it is a calendar year-end company). This is regardless of whether the entity has already or has not yet adopted Topic 842. [ICAO SEC Regs Comm 07/2020.III.A1](#)

For example, even if calendar year-end non-EGC Entity A has already adopted Topic 842 as of January 1, 2021, its IPO registration statement financial statements are adjusted to reflect adopting Topic 842 as of January 1, 2019. The entity presents the effects of Topic 842 in all periods presented from that date.

By contrast, during and after the IPO registration process, an EGC is permitted to use the Topic 842 adoption dates for non-PBEs (i.e. January 1, 2022 for annual periods and January 1, 2023 for interim periods). Question 13A.2.140 addresses adoption guidance for an entity when it loses its EGC status.

## 13B.2 Transition principles – lessees and lessors



### **Excerpt from ASC 842-10**

#### **65 Transition and Open Effective Date Information**

##### **General**

> Transition Related to Accounting Standards Updates No. 2016-02, *Leases (Topic 842)*, No. 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*, No. 2018-10, *Codification Improvements to Topic 842, Leases*, No. 2018-11, *Leases (Topic 842): Targeted Improvements*, No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, 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*, No. 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*, No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*, No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*, and No. 2023-01, *Leases (Topic 842): Common Control Arrangements*

**65-1** The following represents the transition and effective date information related to Accounting Standards Updates No. 2016-02, *Leases (Topic 842)*, No. 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for*

*Transition to Topic 842, No. 2018-10, Codification Improvements to Topic 842, Leases, No. 2018-11, Leases (Topic 842): Targeted Improvements, No. 2018-20, Leases (Topic 842): Narrow-Scope Improvements for Lessors, 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, No. 2020-05, Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities, No. 2021-05, Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments, No. 2021-09, Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities, and No. 2023-01, Leases (Topic 842): Common Control Arrangements: [Note: See paragraph 842-10-S65-1 for an SEC Staff Announcement on transition related to Update 2016-02.]*

- 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).

### Practical expedients

- 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.
- g. An entity also may elect a practical expedient, which must be applied consistently by an entity to all of its leases (including those for which the entity is a lessee or a lessor) to use hindsight in determining the **lease term** (that is, when considering lessee options to extend or terminate the lease and to purchase the **underlying asset**) and in assessing impairment of the entity's **right-of-use assets**. This practical expedient may be elected separately or in conjunction with either one or both of the practical expedients in (f) and (gg).
- 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 under Topic 840 shall not be eligible for this practical expedient for those land easements.

### **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-S99-6 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.

### 13B.2.1 Transition approach – general

13B.2.10 When an entity elects the comparative method, it recognizes and measures all leases that exist at the beginning of the earliest comparative period presented using a modified retrospective transition approach. The entity records a cumulative-effect adjustment at the date of initial application. Comparative periods are presented in accordance with the transition period guidance in Topic 842. All leases that either (1) commence, or (2) are modified (where that modification is not accounted for as a separate contract) or remeasured on or after the effective date are accounted for under Topic 842. [842-10-65-1(c) – 65-1(d), 65-1(q), 65-1(t)]

13B.2.20 As an exception, a lessee electing the recognition and measurement exemption for short-term leases (see section 6.3.1) does not apply the transition requirements to short-term leases. For purposes of this exception, a short-term lease is a lease with a *total* lease term of 12 months or less (including periods before the effective date); it is not a lease with a *remaining* lease term of 12 months or less at the effective date. See Question 13B.2.60 for considerations about whether a lease is a short-term lease in transition if using hindsight. [842-10-65-1(e)]

13B.2.30 Topic 842 does not specify what to do instead for unrecognized short-term leases in transition. However, we believe the lessee should:

- recognize the minimum rental payments (as defined in Topic 840 – see Question 13B.3.10) as lease cost, on a generally straight-line basis over the lease term, consistent with the lessee's accounting for those leases under Topic 840; and
- consistent with all other lessee leases that exist at the effective date, apply the new requirements in Topic 842 to that lease if, on or after the effective date:
  - it is modified and that modification is not accounted for as a separate contract (see section 6.7); or
  - there is an event that would require remeasurement of the lease liability if it were recognized – e.g. a change in the lease term or in the assessment of a lessee purchase option (see section 6.6).

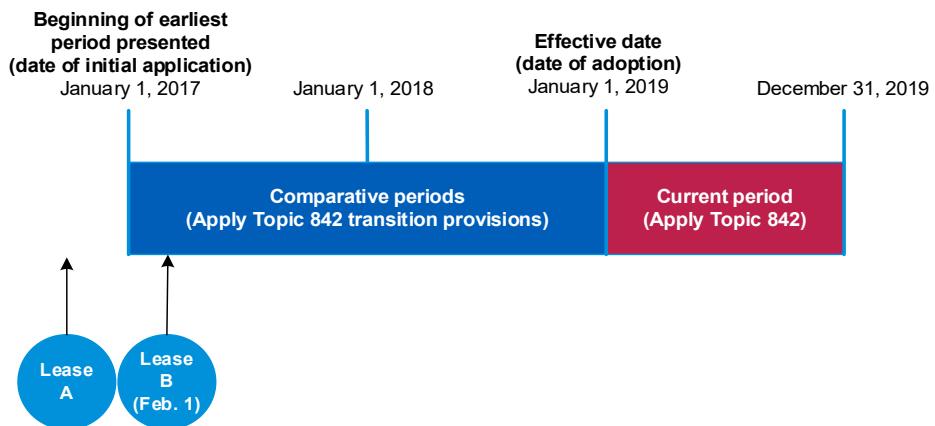
13B.2.40 An entity adjusts equity at the beginning of the earliest comparative period presented, and the other comparative amounts disclosed for each prior period presented, as if Topic 842 had always been applied, subject to the transition requirements described in this chapter. [842-10-65-1(d)]

13B.2.50 An entity applies the transition requirements to leases that commence before the effective date (or early adoption date) at the later of: (1) the beginning of the earliest period presented in the financial statements, or (2) the commencement date (see section 5.1). For ease of reference, this date is referred to as the 'transition date' in this chapter. [842-10-65-1(k), 65-1(r), 65-1(s), 65-1(v), 65-1(w), 65-1(x), 65-1(y)]

13B.2.60 The following diagram is based on a calendar year-end public business entity that adopts Topic 842 on the mandatory effective date. The transition requirements apply to:

- Lease A at the beginning of the earliest period presented – i.e. January 1, 2017 is the transition date; and

- Lease B at the commencement date of the lease – i.e. February 1, 2017 is the transition date.



### 13B.2.2 Transition approach – modifications

13B.2.70 The following transition requirements apply to modifications that are not accounted for as a separate contract, for both lessees and lessors.

[842-10-65-1(q), 65-1(t), 65-1(x)(4)]

Modification occurs ...		
Before beginning of earliest period presented: — Apply Topic 840.	After beginning of earliest period presented but before effective date (i.e. during the transition period): — Apply interpretive guidance in Question 13B.2.10.	On or after effective date: — Apply the requirements of Topic 842 in accounting for the modification and in accounting for the lease on and after the effective date of the modification. See section 6.7 (lessees) and section 7.6 (lessors).

#### Question 13B.2.10 Accounting for modifications that occur during the transition period

#### Which guidance, Topic 842 or Topic 840, applies to lease modifications that occur during the transition period?

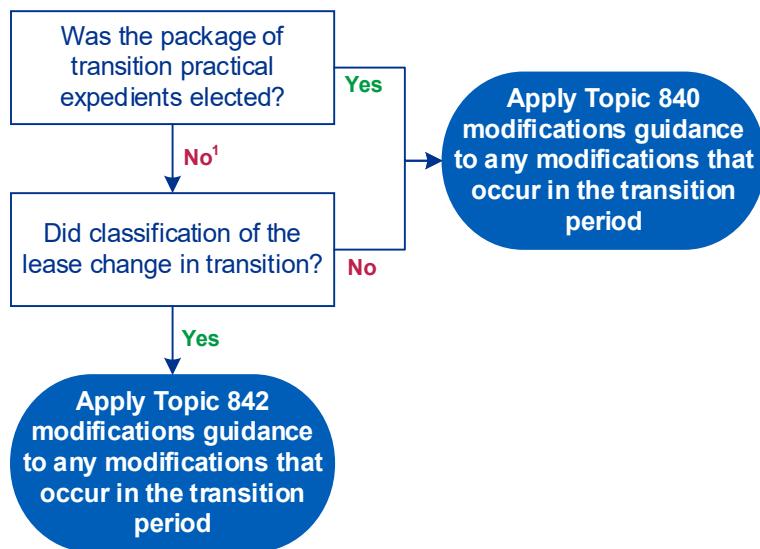
**Background:** The transition period is the period that falls between the date of initial application and the effective date. In the diagram under paragraph 13B.2.60, the transition period is from January 1, 2017 to December 31, 2018.

**Interpretive response:** It depends. Topic 842 is not explicit in this respect; however, we believe if the classification of the lease did *not* change as a result of the transition guidance, the entity should apply the Topic 840 guidance to any modification that occurred before the effective date of Topic 842, which includes the transition period.

Consequently, if the entity elects the package of transition practical expedients, and will not therefore reassess lease classification in transition (see paragraph 13B.2.100), it will apply the Topic 840 guidance to *all* modifications that occur before the effective date.

In contrast, if the entity does not elect the package of transition practical expedients, the classification of some leases may change in transition (see Question 13B.2.20). For those leases only, in transition, the entity will apply the Topic 842 guidance to any modifications that occur during the transition period.

This guidance is further illustrated in the following diagram.



Note:

- Classification of the lease is reassessed if the package of transition practical expedients is not elected. See paragraph 13B.2.100.

We believe this approach is consistent with the transition guidance for lessees and lessors overall. In general, the transition guidance appears to have been written to minimize instances in which a lessee or lessor would have to revise accounting that occurred under Topic 840 unless the classification of the lease changed, in which case the entity would generally apply Topic 842 either from the date of initial application forward (lessees) or as if the lease had always been accounted for based on its revised Topic 842 lease classification (lessors). [842-10-65-1(o), 65-1(s), 65-1(w), 65-1(y), ASU 2016-02.BC390]

13B.2.80 In the diagram in paragraph 13B.2.60:

- If Lease B is modified on March 15, 2019 (i.e. after the effective date), the modification will be accounted for under Topic 842.

- If Lease B is modified on February 15, 2018 (i.e. during the transition period), the interpretive guidance in Question 13B.2.10 applies. The entity will account for the modification in accordance with Topic 840 if the classification of the lease does not change in transition, and in accordance with Topic 842 if the classification does change.

13B.2.90 Lessees will not reassess or remeasure leases before the effective date. Beginning on the effective date, the same reassessment and remeasurement requirements apply to leases that commenced before the effective date as apply to new leases that commence on or after the effective date – i.e. Topic 842 applies in: [842-10-65-1(q), 65-1(t)]

- determining when to reassess a lease and whether there is a resulting remeasurement (see section 6.6.1);
- accounting for the remeasurement (see section 6.6.2); and
- accounting for the lease after the remeasurement (see section 6.6.2).

### 13B.2.3 Practical expedients

13B.2.100 The following table summarizes the three transition practical expedients in Topic 842. An entity electing the land easement practical expedient only applies the transition guidance in Topic 842, including the following practical expedients, to land easements that were *accounted for* as leases under Topic 840. [842-10-65-1(f) – 65-1(gg)]

Package of practical expedients	Use of hindsight	Land easements
<p>On transition, an entity may elect <i>not</i> to reassess:</p> <ul style="list-style-type: none"> <li>— whether expired or existing contracts contain a lease under the new definition of a lease (see chapter 3);</li> <li>— lease classification for expired or existing leases – see sections 6.2 (lessees) and 7.2 (lessors); and</li> <li>— whether previously capitalized initial direct costs would qualify for capitalization under Topic 842 (see section 5.5).</li> </ul> <p>An entity electing this practical expedient must elect the entire package.</p>	<p>An entity may use hindsight in determining the lease term, assessing the likelihood that a lessee renewal, termination or purchase option will be exercised (see section 5.3).</p>	<p>An entity may elect not to reassess whether land easements meet the definition of a lease if they were not accounted for as leases under Topic 840. Section 13B.2.4 discusses this practical expedient in further detail.</p>
Each of the three practical expedients may be elected separately from the other two.		
Practical expedients are applied consistently to all leases – i.e. all leases for which the entity is a lessee or a lessor – that commence before the effective date.		

13B.2.110 Lease modifications that occur before the effective date do not affect the availability of the practical expedients. If an entity modifies its contracts that are leases under Topic 840 but would not be leases under Topic 842 during the transition period (between January 1, 2017 and December 31, 2018 in the diagram in paragraph 13B.2.60) and has elected the package of practical expedients, the entity would apply the Topic 840 definition of a lease to the modified contract(s). In addition, unless there are additional modifications on or after January 1, 2019 (see the effective date in the diagram in paragraph 13B.2.60), the entity will not evaluate whether those contracts are leases under Topic 842. [842-10-65-1(f)]

13B.2.120 An entity that elects to apply all of the practical expedients will, in effect, continue to account for existing leases – i.e. leases for which the commencement date is before the effective date – in accordance with Topic 840 throughout the entire lease term, including periods after the effective date. The following are exceptions to this general principle. [ASU 2016-02.BC390]

Lessees only	Lessees and lessors
Recognize an ROU asset and a lease liability for all operating leases at each reporting date (see section 13B.3). Apply the Topic 842 reassessment requirements (see section 6.6) beginning on the effective date and, if the lease liability is remeasured on or after the effective date, account for the lease under Topic 842 beginning on the remeasurement date (see paragraph 13B.2.90).	If the lease is modified and not accounted for as a separate contract (see sections 6.7 and 7.6 for lessees and lessors, respectively) on or after the effective date, account for the lease under Topic 842 beginning on the effective date of the modification (see paragraph 13B.2.70).

13B.2.130 An entity that elects the land easements practical expedient continues to account for existing land easements (i.e. land easements that commenced before the effective date) consistent with its historical accounting practice before adopting Topic 842. An exception to this general principle arises if a land easement is modified on or after the effective date. [842-10-65-1(gg), ASU 2018-01.BC17]

## Question 13B.2.20 Date of lease classification reassessment

**If an entity does not elect the package of practical expedients, and is therefore required to reassess the classification of its leases, as of what date does that reassessment occur?**

**Interpretive response:** An entity reassesses lease classification for each lease that commences before the effective date of Topic 842 as of the later of:

- the commencement date for the lease; or
- the date of the last lease modification that occurred before the date of initial application that, in accordance with Topic 840, required the entity to reassess the classification of the lease.

Any lease modification that occurs *after* the transition date (i.e. during the transition period) for the lease should be accounted for as outlined in Question 13B.2.10. However, such modifications do not affect the date of the entity's initial reassessment of lease classification under Topic 842 if the package of practical expedients is not elected.



### Question 13B.2.30

#### **Hindsight practical expedient – effect on lease classification if package of practical expedients elected**

**If an entity elects both the package of practical expedients and the use of hindsight, is it required to reassess lease classification if hindsight results in a change to the lease term or the assessment of a lessee purchase option?**

**Interpretive response:** No. Topic 842 does not establish a hierarchy between these two transition practical expedients such that hindsight overrides the package of practical expedients. Therefore, even though changes to the lease term or the assessment of a lessee purchase option resulting from the use of hindsight require, for example, the lessee to remeasure the minimum rental payments (existing operating leases) or the minimum lease payments (existing capital leases – see Question 13B.2.50), we do not believe an entity (lessee or lessor) is required to reassess lease classification if it has elected the package of practical expedients.

However, we also do not believe that Topic 842 *precludes* reassessing lease classification in such cases. This is on the basis that the hindsight practical expedient was intended to permit entities to provide more accurate, updated information to financial statement users unhindered by their decisions with respect to other transition practical expedients – e.g. the package of practical expedients. [ASU 2016-02.BC394]



### Question 13B.2.40

#### **Hindsight practical expedient – lessee options**

**Does the hindsight practical expedient require an entity to reassess the lease term and any lessee purchase options? If yes, at what date does that reassessment occur and what factors does it consider?**

**Interpretive response:** Yes, election of the hindsight practical expedient requires an entity (lessee or lessor) to reevaluate the lease term and the entity's assessment of any lessee purchase options on the effective date of Topic 842.

The reassessment takes into account all economic factors relevant to that assessment as of the effective date: contract-based, asset-based, market-based and entity-based factors (see paragraph 5.2.60). That is, an entity assesses as of the effective date, with the benefit of hindsight, the same factors it considers at lease commencement for new leases that commence on or after the effective date. The entity then uses that updated information to establish the measurement of the lease at the transition date – i.e. rather than the entity's 'reasonably assured' assessment that it undertook under Topic 840.

This requirement, resulting from election of the hindsight practical expedient, is regardless of:

- the fact that lessors do not reassess such items for leases that commence *on or after* the effective date of Topic 842 (unless the lease is modified and that modification is not accounted for as a separate contract); and
- whether or not any 'triggering events' (i.e. significant events or changes in circumstances within the control of the lessee) have occurred before the effective date.

The following are examples (which would apply equally to the lessee or the lessor).

— **Example 1: Changes in market value**

A lessee concluded at lease inception under Topic 840 that exercise of a renewal option was not reasonably assured and the lease term excluded the optional renewal period.

On the effective date of Topic 842, it is clear that the renewal option will be a significant bargain from fair market rent for the underlying asset at the time of renewal such that it is reasonably certain (based on market factors) that the lessee will exercise the renewal option.

Therefore, when applying hindsight, the remaining lease term used to measure the lease at the transition date will include the optional renewal period.

— **Example 2: Impact of leasehold improvements**

A lessor concluded at lease inception under Topic 840 that exercise of a renewal option by the lessee was not reasonably assured and excluded the optional renewal period from the lease term.

By the effective date of Topic 842, the lessee has constructed significant leasehold improvements that will have significant remaining economic value to the lessee after the optional renewal date such that the lessee is reasonably certain to exercise the renewal option.

Therefore, when applying hindsight, the remaining lease term used to measure the lease at the transition date will include the optional renewal period.

Subsequent to the effective date – i.e. after the entity undertakes the hindsight reassessment – leases that commenced before the effective date are reassessed on the same basis as new leases that commenced on or after the effective date. That is, lessors do not reassess the lease term or lessee purchase options unless the lease is modified (and that modification is not

accounted for as a separate contract) – see section 7.6, and lessees reassess the lease term only as discussed in section 6.6 on reassessments and section 6.7 on modifications.



### Question 13B.2.50

#### **Hindsight practical expedient – existing capital (sales-type/direct financing) leases**

**If hindsight results in a change to the lease term or the assessment of a lessee purchase option, does an entity remeasure an existing capital (sales-type/direct financing) lease if its classification does not change on transition?**

**Background:** Topic 842 states that:

- The lease liability and ROU asset for an existing capital lease that remains classified as a finance lease under Topic 842 are initially measured at the transition date as follows (see paragraph 13B.3.100). [842-10-65-1(r)(1) – 65-1(r)(2)]
  - **Lease liability:** Carrying amount of capital lease obligation under Topic 840 immediately before the transition date.
  - **ROU asset:** Carrying amount of the capital lease asset under Topic 840 immediately before the transition date, plus any unamortized initial direct costs not included in the capital lease asset.
- The net investment in the lease at the transition date for a sales-type or direct financing lease that remains classified as a sales-type or direct financing lease under Topic 842 is measured at the carrying amount of the net investment immediately preceding the transition date under Topic 840 (see paragraph 13B.4.40). [842-10-65-1(x)(1)]

**Interpretive response:** Yes. If hindsight results in a change to the lease term or the assessment of a lessee purchase option, the lease assets and lease liabilities should be remeasured. This is notwithstanding the Topic 842 transition paragraphs referenced in the background.

Election of the hindsight practical expedient is optional; therefore, the decision to apply this practical expedient includes acceptance of the remeasurement requirements that accompany that decision. The hindsight practical expedient, if elected, is intended to provide more accurate, updated information to financial statement users. It is unclear how that would be accomplished if the use of hindsight results in a changed lease term or changed assessment of a lessee purchase option but the entity does not reflect that change in its measurement of lease assets and lease liabilities. [ASU 2016-02.BC394]



## Question 13B.2.60

### Hindsight practical expedient – short-term leases

**Does the exercise of one or more renewal options that result in a cumulative lease term greater than 12 months preclude accounting for the lease as a short-term lease when applying the hindsight practical expedient on transition?**

**Background:** Consider an example whereby Lessee LE enters into a lease that commences on January 1, 2017 that has a non-cancellable period of 12 months and three 12-month lessee renewal options. At January 1, 2017, it is not reasonably certain that LE will exercise any of the renewal options; therefore, the lease term is 12 months.

As of the effective date (January 1, 2019 for LE), LE has exercised two of the renewal options – i.e. as of the effective date, the current non-cancellable period of the lease extends to December 31, 2019. At no point in time before exercise was it ever ‘reasonably certain’ that LE would exercise one or more of those options (see section 5.2), and it is not reasonably certain at the effective date that LE will exercise its one remaining option to extend the lease to December 31, 2020.

LE has elected the hindsight transition practical expedient, and is now considering whether this lease qualifies for the short-term lease recognition and measurement exemption given LE knows that the lease will have a total term, in hindsight, of at least three years.

**Interpretive response:** It depends. If the initial lease term was 12 months or less and no single renewal option exercised by the lessee up to the effective date extended the lease term by more than 12 months from the end of the previously determined lease term, the lease qualifies as a short-term lease on transition; this is even if the lessee elected the hindsight practical expedient.

Therefore, in the background example, the lease qualifies as a short-term lease, despite LE’s use of the hindsight practical expedient. This is because the original lease term was 12 months or less and neither of the two renewal options exercised by LE extended the lease term by more than 12 months from the end of the then-current lease term at the point in time the option was exercised.

However, a lease such as that in the background example would not qualify, if using hindsight, as a short-term lease for any portion of the transition period if any *single* renewal option was exercised that extended the lease term by *more than* 12 months from the end of the previously determined lease term or if LE had exercised more than one of the available 12-month renewal options during the same then-current 12-month lease term. For example, if the background lease had an initial term of 12 months, but LE exercised a single 24-month renewal option, rather than two 12-month renewal options, or had exercised both of the two 12-month renewal options during the initial 12-month term of the lease, it would not be considered a short-term lease.

While not explicit in the guidance, we believe this interpretation of the Topic 842 transition guidance is consistent with the post-transition guidance that says a lease does not lose its short-term categorization unless the lease term changes such that, after the change, the remaining lease term extends more than 12 months from the end of the previously determined lease term. [842-20-25-3]



### Question 13B.2.70

#### Hindsight practical expedient – changes to straight-line operating lease income (expense)

**If the lease term changes as a result of applying the use-of-hindsight practical expedient, does the entity need to revise its straight-line income (expense) recognition?**

**Background:** Lessor LR and Lessee LE are public business entities that entered into a five-year lease that commenced on January 1, 2014. The lease included a five-year lessee renewal option, which LR and LE both excluded from the lease term in their historical accounting.

Both LR and LE classified the lease as an operating lease under Topic 840, and concluded that income (expense) should be recognized on a straight-line basis. The annual payments for the lease increase by 5 percent each year, including during the optional renewal period.

By the effective date of Topic 842 (January 1, 2019) LE has exercised the renewal option to extend the term of the lease. Both LR and LE elect the use-of-hindsight practical expedient.

**Interpretive response:** Yes. If the lease term changes as a result of hindsight, the entity is required to adjust all of its related accounting correspondingly.

This means that if the income (expense) recognized in the comparative periods presented in the financial statements would have been different from what was historically reported, the entity must retrospectively adjust those amounts in its post-adoption financial statements. In the case of the background example, the entity would recognize any necessary adjustment to equity for amounts of income (expense) that would have been recognized before LR and LE's date of initial application (January 1, 2017).

Using the background example, because of the annual 5% payment escalator, LR and LE would have recognized additional lease income (expense) in January 1, 2014 to December 31, 2018 had they both estimated a lease term of 10 years rather than 5 years. The use of hindsight by LR and LE means they will recognize less lease income (expense) after the effective date than they would have had they not elected the use-of-hindsight practical expedient.



### Question 13B.2.80

#### **Hindsight practical expedient – remeasurement events**

**When applying hindsight, does a remeasurement arising from an event that occurs, or change in circumstances that arises, on or after the effective date affect measurement of the lease at the transition date?**

**Interpretive response:** No. As outlined in Question 13B.2.40, election of the hindsight practical expedient requires an entity (lessee or lessor) to reevaluate the lease term and the entity's assessment of any lessee purchase options as of the later of the beginning of the earliest period presented and the lease commencement date (i.e. the transition date) for each of its leases based on the entity's *effective date* consideration of all economic factors relevant to that assessment: contract-based, asset-based, market-based and entity-based factors (see paragraph 5.2.60).

After that effective date reassessment occurs, any changes to the lease term or to the assessment of lessee purchase options that result from applying the guidance in Topic 842 (e.g. resulting from a 'triggering event' for lessees or from the reassessment of the lease upon a modification that is not accounted for as a separate contract for lessees and lessors) are post-transition accounting events that are not 'pushed back' to the transition date for that lease.



### Question 13B.2.90

#### **Hindsight practical expedient – modifications and changes to an index or rate on which variable lease payments are based**

**Does using hindsight contemplate changes to the terms or conditions of the lease after the transition date, or changes to a reference index or rate?**

**Interpretive response:** No. We believe using hindsight is intended to apply to estimates and other matters of judgment, such as assessments the entity made at lease inception under Topic 840 about the likelihood that the lessee will exercise an option to renew (or terminate) the lease or exercise an option to purchase the underlying asset.

We do not believe the Board intended for entities to use the hindsight practical expedient to reflect changes in fact, such as changes to contractual terms or conditions of the lease or factors that affect the amount of variable lease payments as though those changes occurred before they actually did.

Therefore, an entity should *not* reflect, at the transition date, the effects of either:

- changes to the actual terms or conditions of the lease contract that occurred after the transition date;<sup>1</sup> or

- a reference index or rate that exists in the future from the transition date – e.g. the entity does not use the CPI at the effective date when accounting for the lease as of the transition date. When measuring the lease liability for a lease at the transition date, an entity should use the index or rate as indicated in Question 13B.3.30.

Note:

1. Exercise of an option included in the contract is not a change to the terms or conditions thereof. Consequently, applying hindsight does not contemplate options exercised or not exercised by an entity.



### Example 13B.2.10

#### Applying hindsight with lease remeasurements and modifications

This example illustrates the interpretive guidance provided in Questions 13B.2.30 – 13B.2.50 about applying the hindsight practical expedient in evaluating lease remeasurements and modifications.

The following table summarizes relevant information about Lessee LE's lease of a warehouse facility from Lessor LR. LE and LR have both elected to use the package of transition practical expedients and the hindsight practical expedient.

Commencement date of lease:	January 1, 2004
Lease term:	15 years
Terms of renewal options:	One 10-year option. LE must notify LR six months before the end of the term that LE will not exercise the option or the option is deemed exercised. At lease inception, exercise of the renewal option by LE is not reasonably assured.
Effective date for LE:	January 1, 2019
Date of initial application for LE:	January 1, 2017

#### Scenario 1: Lessee option exercised during transition period

LE did not notify LR of its intent to terminate the lease on or before July 1, 2018. As a result, because July 1, 2018 represents six months before the end of the original lease term, the renewal option has been exercised in accordance with the terms of the contract.

In this scenario, the remaining lease term is 12 years for both LE and LR as of January 1, 2017 (transition date for the lease) – i.e. two years remaining from the original term plus the 10-year renewal period. The lease term at January 1, 2017 should include consideration of the event (exercise of the renewal option) that occurred during the transition period and before the January 1, 2019 effective date.

#### Scenario 2: Lessee option exercised after the effective date

Assume the same facts as in Scenario 1, except the commencement date of the lease was January 1, 2005 and therefore the non-cancellable period of the lease ends December 31, 2019. This means that the date by which LE must

notify LR of its intent not to exercise the extension option is July 1, 2019 (rather than July 1, 2018).

In this scenario, if the entity (LE or LR) concludes, based on consideration of all relevant economic factors as of the effective date (see Question 13B.2.40), that LE is reasonably certain to extend the lease beyond December 31, 2019, the remaining lease term will be 13 years (January 1, 2017 – December 31, 2029) at the transition date.

If LE is not reasonably certain to exercise the option to extend the lease as of the effective date, the remaining lease term is only three years (January 1, 2017 – December 31, 2019) at the transition date. If lessee exercises the option on July 1, 2019, that extension of the lease term does not affect the conclusion reached that the remaining lease term *at the transition date* is three years. The exercise of the option is solely a ‘post-transition’ accounting event for both LE and LR.

### **Scenario 3: Lease modification during the transition period**

Assume the same facts as Scenario 2, except that the lease does not include a renewal option for LE. However, LE and LR agree on February 1, 2018 to modify the lease to extend its term for 10 years following the end of the non-cancellable period of the lease (December 31, 2019).

Despite the fact that the modification occurred during the transition period, the lease term extension resulting from the modification is not reflected in the remaining lease term at the transition date for the lease (i.e. January 1, 2017). Therefore, the remaining lease term at January 1, 2017 is three years (January 1, 2017 – December 31, 2019). The change in the lease term resulting from the modification is not reflected in the financial statements until the modification date.



## Question 13B.2.100 Errors in applying Topic 840

### **Does election of the package of practical expedients require entities to correct errors in applying Topic 840 with respect to lease identification, lease classification and the accounting for initial direct costs?**

**Interpretive response:** Yes. Election of the package of practical expedients does not grandfather errors in applying Topic 840; it only grandfathers the Topic 840 guidance.

Therefore, if the package of practical expedients is elected, incorrect conclusions reached under Topic 840 about the following must be corrected, separate from the transition accounting for those leases, *in accordance with the guidance in Topic 840*:

- whether a contract is or contains a lease (including incorrect conclusions about whether a contract or part of a contract was in the scope of Topic 840);

- lease classification; and/or
- the accounting for initial direct costs.

The effect of correcting an error in applying Topic 840 is excluded from the transition effect of applying Topic 842. An entity corrects any error under Topic 840 before applying the transition guidance in Topic 842. For example, if an entity wrongly concluded that a contract did not contain a lease under Topic 840, the entity would recognize that lease in transition even if that contract would not contain a lease under Topic 842. For the specific requirements related to land easements, see section 13B.2.4 [IASU 2016-02.BC393(a)]

Identifying a lease may be the most likely area of error to which the package of practical expedients applies. Many contracts convey the right to use property, plant or equipment, but are not explicitly identified as 'lease agreements'. Examples include service contracts (including contracts for IT services), dedicated supply agreements, advertising and construction contracts. Under Topic 840, an entity may not have had a significantly different expense recognition pattern or balance sheet treatment regardless of whether a transaction was accounted for as an operating lease or as an executory or service contract. Accordingly, entities may not have previously focused their efforts on identifying contracts that explicitly or implicitly contained operating leases.

However, under Topic 842 identifying leases becomes much more important because entities recognize lease liabilities and ROU assets on the balance sheet for each lease with a term that is longer than 12 months. Accordingly, the Board decided that the package of practical expedients should not provide an exemption for arrangements that were not accounted for as leases under Topic 840 even though they met the Topic 840 definition.



**Question 13B.2.110**

**Grandfathering arrangements committed or agreed to before reporting periods beginning after May 28, 2003**

**Are arrangements that were grandfathered from application of the lease identification guidance in Topic 840 still grandfathered on transition to Topic 842?**

**Background:** Under Topic 840, arrangements not accounted for as leases that were committed or agreed to before reporting periods beginning after May 28, 2003 (and not subsequently modified or acquired in a business combination) were grandfathered from determining whether the arrangement is or contains a lease.

**Interpretive response:** Yes, but only if the entity elects the package of transition practical expedients. Topic 842 does not carry forward that grandfathering provision, so unless the package of practical expedients is elected, the entity must reassess whether leases exist for all arrangements that

have not ended before the date of initial application (i.e. the beginning of the earliest period presented).

However, the package of practical expedients grandfathers the Topic 840 lease identification guidance for all leases that commence before the effective date of Topic 842. We believe this includes the grandfathering provision in Topic 840. Therefore, if an entity elects the package of practical expedients, leases previously eligible for this grandfathering provision would remain eligible for that provision.

Because the grandfathering provision in Topic 840 does not apply to leases modified after May 28, 2003, entities will need to have a process in place to ensure that any modified contracts initially eligible for the grandfathering provision were reassessed under Topic 840 upon modification, as well as a process in place to monitor any such contracts for modifications that occur on or after the effective date of Topic 842. If a contract previously eligible for the Topic 840 grandfathering provision is modified on or after the effective date, the entity will have to assess whether the contract is or contains a lease under Topic 842.



### Observation

#### **Impact on initial direct costs for entities not electing the package of practical expedients**

13B.2.140 An entity's decision not to elect the package of practical expedients for lease definition, lease classification and initial direct costs may not have a significant effect on the entity unless it has previously incurred a significant amount of initial direct costs. This is because the new definition of a lease and the new lease classification guidance will likely yield similar outcomes to the related guidance in Topic 840 in most cases (assuming no errors in applying Topic 840 – see Question 13B.2.100). However, because substantially fewer costs qualify as initial direct costs under Topic 842 (see section 5.5), the effect of electing (or not electing) the package of practical expedients may be significant for entities that incur significant lease origination costs.

[ASU 2016-02.BC393(c)]

## 13B.2.4 Land easements

13B.2.150 A land easement is, in general, a right to use and/or enter (or cross) land owned by another party for a specific purpose, for which the rights vary depending on the easement. Land easements may be perpetual or for a defined term, may be prepaid or paid over time, and may provide for exclusive or nonexclusive (shared) use of the land. For a discussion of land easements and the scope of Topic 842, see Question 2.3.10.

13B.2.160 As some entities did not assess whether land easements met the definition of a lease under Topic 840, stakeholders expressed concern to the Board that it would be costly and complex to evaluate those land easements in transition. As a result, the Board added an optional transition practical expedient specifically for land easements. It allows an entity to elect not to assess

whether any expired or existing land easements are, or contain, leases at transition if they were not previously *accounted for* as leases under Topic 840. An entity that elects this practical expedient should assess any new or modified land easements on or after the effective date under Topic 842.

13B.2.170 This practical expedient does not apply to any land easements that *were* previously accounted for as leases under Topic 840. Such land easements are subject to the same transition guidance as other identified leases.

13B.2.180 This practical expedient is available separately, or in conjunction with either or both of the other practical expedients: the all-or-nothing package of practical expedients, and the ability to use hindsight (see section 13B.2.3). An entity that does not elect the land easements practical expedient must either:

- If the package of practical expedients is not elected: reassess whether its land easements meet the Topic 842 definition of a lease; or
- If the package of practical expedients is elected: ensure that its Topic 840 conclusions about whether its land easements were, or contained, leases were correct (see Question 13B.2.100).



## Observation

### Prior land easement accounting is grandfathered

13B.2.190 The Board specifically provided this transition practical expedient for land easements that were not *accounted for as leases* under Topic 840, rather than land easements that were not *assessed* under Topic 840. In practical terms, this means that land easements that were accounted for under non-lease guidance do not need to be reassessed to determine if they met the definition of a lease either under Topic 840 (if the package of practical expedients is elected) or Topic 842 (if the package of practical expedients is not elected) before transition. As a result, election of the practical expedient will essentially grandfather the legacy accounting for any land easements that exist at (i.e. have commenced before) the effective date of Topic 842, including any erroneously determined not to be a lease under Topic 840.

13B.2.200 This differs from other transition guidance in Topic 842, which specifies that errors in the application of Topic 840 are not grandfathered (see Question 13B.2.100). If an entity does not elect this practical expedient, it cannot overlook land easements that were erroneously not accounted for as leases under Topic 840, even if the entity elects the package of practical expedients. [ASU 2016-02.BC393(a)]



## Question 13B.2.120

### Land easements arising before the effective date

#### Can an entity change its accounting policy for land easements before the effective date of Topic 842?

**Interpretive response:** No. An entity that elects the optional transition practical expedient for land easements is required to continue to apply consistent accounting policies to new or modified contracts entered into before the effective date of Topic 842. Therefore, an entity that previously accounted for land easements under Topic 840 should continue to apply Topic 840 to new land easements arising before the effective date. For example, a new ground lease agreement (which could be characterized as a land easement) commencing before the effective date of Topic 842 is not eligible for the practical expedient because similar ground leases had previously been accounted for by the entity as leases under Topic 840. [\[ASU 2018-01.BC17\]](#)

Alternatively, if the entity has historically accounted for a population of land easements under other guidance (e.g. Topics 350 or 360), the entity should continue to apply that accounting policy to all similar land easements entered into before the effective date of Topic 842. In this case, the entity is eligible to apply the practical expedient to those land easements in transition.

## 13B.2.5 Disclosures

13B.2.210 In addition to the ongoing disclosures required by Topic 842 for lessees and lessors, an entity generally provides the transition disclosures required for accounting changes and error corrections. As an exception, an entity is not required to disclose the effect of the change on income from continuing operations, net income and per-share amounts for the (1) interim and annual periods post-adoption, or (2) prior periods retrospectively adjusted. [\[842-10-65-1\(i\), 250-10-50-1\(b\)\(2\), 250-10-50-3\]](#)

13B.2.220 If an entity elects the package of practical expedients, the practical expedient to use hindsight and/or the land easements practical expedient, it discloses that fact. [\[842-10-65-1\(j\)\]](#)

13B.2.230 Before the effective date, SEC registrants are required to evaluate new accounting standards that they have not yet adopted and to disclose their potential material effects. These disclosures generally should include a discussion about the effect that adoption is expected to have on the financial statements, unless this is not known or reasonably estimable. [\[SAB Topic 11.M\]](#)

13B.2.240 While Topic 842 requires only certain lessor disclosures to be made in all interim financial statements, Article 10 of Regulation S-X requires SEC registrants to provide both the applicable lessor and lessee annual and interim disclosures in each interim period included in the entity's quarterly reports on Form 10-Q in the year of adoption of a new accounting standard (see Question 12.1.20).



## Observation

### Effect of adoption on the financial statements

13B.2.250 In various forums, including public meetings, that included members of the preparer and practitioner communities, members of the SEC staff have stated that an entity asserting in its financial statements that the effect of adoption of Topic 606 will not be material needs to consider the effect of the new disclosure requirements. That is, even though the basic financial statements may not be materially affected, the information in the significant new disclosures could be a material effect on the financial statements, which include the notes. While this comment has most frequently been made in the context of comments about the adoption of Topic 606, we believe the SEC staff would hold a similar view about an entity's SAB 74 disclosures in relation to the new leases standard.

13B.2.260 We believe some entities, many lessors in particular, may conclude that the effect of Topic 842 on their basic financial statements will not be material but that they will have to make significant new disclosures. Those entities should be cognizant of this guidance from the SEC staff. Meanwhile, lessees and others that anticipate a material effect from adoption should discuss the substantial new Topic 842 disclosure requirements in their pre-adoption SAB 74 disclosures in addition to the other anticipated effects on their financial statements.



## Question 13B.2.130

### Disclosures in comparative periods

## Do the lessee, lessor and sale-leaseback disclosure requirements in Topic 842 apply to comparative periods presented in the post-adoption financial statements?

**Interpretive response:** Yes. Under the comparative method, the disclosure requirements apply to the comparative periods presented in the financial statements.

When meeting the disclosure requirements, an entity does so based on its accounting in accordance with the Topic 842 transition requirements that apply to the relevant leases. For example (not exhaustive):

- variable lease cost disclosed in accordance with paragraph 842-20-50-4(d) will not include variable payments of executory costs that were not considered contingent rent under Topic 840;
- the operating lease income disclosure required by paragraph 842-30-50-5(b) will disclose lease income relating to the minimum rental payments – i.e. rather than the ‘lease payments’; and
- gains or losses arising from sale-leaseback transactions disclosed in accordance with paragraph 842-40-50-2(b) will be based on the gain or loss (inclusive of any portion originally deferred under Topic 840) that was

calculated under Topic 840 – i.e. rather than the gain or loss that might have resulted from applying the guidance in Topic 842.

## 13B.3 Transition for lessees



### Excerpt from ASC 842-10

#### 65 Transition and Open Effective Date Information

##### General

> Transition Related to Accounting Standards Updates No. 2016-02, *Leases (Topic 842)*, No. 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*, No. 2018-10, *Codification Improvements to Topic 842, Leases*, No. 2018-11, *Leases (Topic 842): Targeted Improvements*, No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, 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*, No. 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*, No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*, and No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*, and No. 2023-01, *Leases (Topic 842): Common Control Arrangements*

**65-1** The following represents the transition and effective date information related to Accounting Standards Updates No. 2016-02, *Leases (Topic 842)*, No. 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*, No. 2018-10, *Codification Improvements to Topic 842, Leases*, No. 2018-11, *Leases (Topic 842): Targeted Improvements*, No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, 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*, No. 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*, No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*, No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*, and No. 2023-01, *Leases (Topic 842): Common Control Arrangements*: [Note: See paragraph 842-10-S65-1 for an SEC Staff Announcement on transition related to Update 2016-02.]

##### Lessees

###### Leases previously classified as operating leases under Topic 840

- k. A lessee shall initially recognize a right-of-use asset and a lease liability at the application date as determined in (c).
- 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):

1. The remaining minimum rental payments (as defined under Topic 840).
  2. Any amounts **probable** of being owed by the lessee under a **residual value guarantee**.
- m. For each lease classified as an operating lease in accordance with paragraphs 842-10-25-2 through 25-3, a lessee shall initially measure the right-of-use asset at the initial measurement of the lease liability adjusted for both of the following:
1. The items in paragraph 842-20-35-3(b), as applicable.
  2. The carrying amount of any liability recognized in accordance with Topic 420 on exit or disposal cost obligations for the lease.
- n. For each lease classified as an operating lease in accordance with paragraphs 842-10-25-2 through 25-3, a lessee shall subsequently measure the right-of-use asset throughout the remaining lease term in accordance with paragraph 842-20-35-3(b). If the initial measurement of the right-of-use asset in (m) is adjusted for the carrying amount of a liability recognized in accordance with Topic 420 on exit or disposal cost obligations for the lease, the lessee shall apply the recognition and subsequent measurement guidance in Sections 842-20-25 and 842-20-35, respectively, when the right-of-use asset has been impaired.
- o. For each lease classified as a finance lease in accordance with paragraph 842-10-25-2, a lessee shall measure the right-of-use asset as the applicable proportion of the lease liability at the commencement date, which can be imputed from the lease liability determined in accordance with (l). The applicable proportion is the remaining lease term at the 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.
- 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.
- 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.

### **Leases previously classified as capital leases under Topic 840**

- 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.
  - 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.
  - 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).
  - 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.
- s. For each lease classified as an operating lease in accordance with this Topic, a lessee shall do the following:
  - 1. Derecognize the carrying amount of any capital lease asset and capital lease obligation in accordance with Topic 840 at the application date as determined in (c). Any difference between the carrying amount of the capital lease asset and the capital lease obligation shall be accounted for in the same manner as prepaid or accrued rent.
  - 2. If an entity elects the transition method in (c)(1) and the lease commenced before the beginning of the earliest period presented in the financial statements or if the entity elects the transition method in (c)(2), recognize a right-of-use asset and a lease liability in accordance with paragraph 842-20-35-3 at the application date as determined in (c).
  - 3. If an entity elects the transition method in (c)(1) and the lease commenced after the beginning of the earliest period presented in the financial statements, recognize a right-of-use asset and a lease liability in accordance with paragraph 842-20-30-1 at the commencement date of the lease.
  - 4. Account for the operating lease in accordance with the guidance in Subtopic 842-20 after initial recognition in accordance with (s)(2) or (s)(3).

5. Write off 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.
- 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.

> Transition Related to Accounting Standards Update No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*

**65-6** The following represents the transition and effective date information related to Accounting Standards Update No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*:

- a. An entity that has not yet adopted the pending content that links to paragraph 842-10-65-1 as of 11/11/2021 shall apply the pending content that links to this paragraph to all new and existing leases when the entity first applies the pending content that links to paragraph 842-10-65-1. That entity 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 (as of 11/11/2021) shall:
  1. 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 as of the beginning of the fiscal year of adoption.
  2. Apply the pending content that links to this paragraph on a modified retrospective basis to leases affected by the amendments existing as of the beginning of the fiscal year of adoption by adjusting the lease liability, which shall be calculated based on the discount rate and remaining lease term at the beginning of the fiscal year of adoption. An entity shall recognize the amount of the change in the lease liability as an adjustment to the corresponding right-of-use asset, unless:
    - i. The carrying amount of the right-of-use asset is reduced to zero, in which case the entity shall recognize any remaining amount of the adjustment to opening retained earnings at the beginning of the fiscal year of adoption.
    - ii. The adjustment would increase a right-of-use asset that was previously impaired, in which case the entity shall record the adjustment to opening retained earnings at the beginning of the fiscal year of adoption.

- c. An entity within the scope of (b) shall not treat the adoption of the pending content that links to this paragraph as an event that would require the entity to:
  - 1. Remeasure and reallocate the consideration in the contract in accordance with paragraph 842-10-15-36.
  - 2. Reassess the lease term or a lessee option to purchase the underlying asset in accordance with paragraph 842-10-35-1.
  - 3. Remeasure the lease payments in accordance with paragraph 842-10-35-4.
  - 4. Reassess lease classification in accordance with paragraph 842-10-25-1.
- d. An entity within the scope of (b) that has adopted the pending content that links to this paragraph shall disclose the following as of the beginning of the fiscal year of adoption (rather than at the beginning of the earliest period presented):
  - 1. The information required by paragraph 250-10-50-1(a) and (b)(3), if applicable
  - 2. The recognized amount of changes in lease liabilities and corresponding right-of-use assets resulting from the transition adjustment.

For an entity within the scope of (b), at the date of adoption of the pending content that links to this paragraph, the entity may choose to apply or discontinue using the risk-free rate for any class of underlying asset.

> Transition Related to Accounting Standards Update No. 2023-01, *Leases (Topic 842): Common Control Arrangements*

**65-7** The following represents the transition and effective date information related to the practical expedient in Accounting Standards Update No. 2023-01, *Leases (Topic 842): Common Control Arrangements*:

- a. The pending content that links to this paragraph shall be effective for fiscal years, including interim periods within those fiscal years, beginning after December 15, 2023. Early adoption is permitted in any annual or interim period for which financial statements have not yet been made available for issuance. If an entity adopts the pending content that links to this paragraph in an interim period, it shall adopt that pending content as of the beginning of the fiscal year that includes that interim period.
- b. An entity that adopts the pending content that links to this paragraph concurrently with adopting the pending content that links to paragraph 842-10-65-1 shall apply the pending content that links to this paragraph using the same transition method elected for the pending content that links to paragraph 842-10-65-1.
- c. An entity that adopted the pending content that links to paragraph 842-10-65-1 before adopting the pending content that links to this paragraph shall apply the pending content that links to this paragraph using either of the following two methods:
  - 1. Prospectively to arrangements that commence or are modified on or after the date that the entity first applies the pending content that links to this paragraph.

2. Retrospectively to the beginning of the period in which the pending content that links to paragraph 842-10-65-1 was first applied. The pending content that links to this paragraph shall not be applicable for arrangements no longer in place at the date of adoption. Under this transition method:
  - i. If an arrangement previously considered to be a lease continues to be a lease after applying the pending content that links to this paragraph, an entity shall apply the requirements in paragraphs 842-10-25-9 through 25-17 to any changes in the lease resulting from application of the practical expedient in the pending content that links to this paragraph. Any amounts that otherwise would have been recognized in earnings shall be recognized as a cumulative-effect adjustment to opening retained earnings (or net assets of a not-for-profit entity) at the beginning of the earliest period presented in accordance with the pending content that links to paragraph 842-10-65-1.
  - ii. If an arrangement previously not considered a lease becomes a lease after applying the pending content that links to this paragraph, an entity shall account for the arrangement as a new lease.
- d. An entity may document any existing unwritten terms and conditions of an arrangement between entities under common control before the date on which the entity's first interim (if applicable) or annual financial statements are available to be issued in accordance with the pending content that links to this paragraph.
- e. An entity within the scope of (c) shall provide the applicable transition disclosures required by Topic 250 on accounting changes and error corrections, except for the requirements in paragraphs 250-10-50-1(b)(2) and 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 earliest period presented but not before the date on which the pending content that links to paragraph 842-10-65-1 was adopted.
- f. An entity that elects the practical expedient(s) in paragraph 842-10-65-1(f) or (g) is not required to apply either of those practical expedites to common control arrangements for which the pending content that links to this paragraph is being applied.

> Transition Related to Accounting Standards Update No. 2023-01, *Leases (Topic 842): Common Control Arrangements*

**65-8** The following represents the transition and effective date information related to the accounting for leasehold improvements associated with leases between entities under common control in Accounting Standards Update No. 2023-01, *Leases (Topic 842): Common Control Arrangements*:

- a. The pending content that links to this paragraph shall be effective for fiscal years, including interim periods within those fiscal years, beginning after December 15, 2023. Early adoption is permitted in any annual or interim period for which financial statements have not yet been made available for issuance. If an entity adopts the pending content that links to this paragraph in an interim period, it shall adopt that pending content as of the beginning of the fiscal year that includes that interim period.

- b. An entity that adopts the pending content that links to this paragraph concurrently with adopting the pending content that links to paragraph 842-10-65-1 may apply the pending content that links to this paragraph using the same transition method elected for the pending content that links to paragraph 842-10-65-1 or may apply the pending content that links to this paragraph using either of the prospective methods specified in (c)(1) and (c)(2) below.
- c. An entity that adopted the pending content that links to paragraph 842-10-65-1 before adopting the pending content that links to this paragraph shall apply the pending content that links to this paragraph using one of the following methods:
  - 1. Prospectively to all new leasehold improvements recognized on or after the date that the entity first applies the pending content that links to this paragraph.
  - 2. Prospectively to all new and existing leasehold improvements recognized on or after the date that the entity first applies the pending content that links to this paragraph. An entity that elects this transition approach shall amortize the remaining balance of leasehold improvements existing at the date of adoption of the pending content that links to this paragraph over the remaining useful life of those improvements to the common control group determined at that date.
  - 3. Retrospectively to the beginning of the period in which the pending content that links to paragraph 842-10-65-1 was first applied. Any leasehold improvements previously amortized or impaired that otherwise would not have been amortized or impaired had the pending content that links to this paragraph been applicable shall be recognized through a cumulative-effect adjustment to the opening balance of retained earnings (or net assets of a not-for-profit entity) at the beginning of the earliest period presented in accordance with the pending content that links to paragraph 842-10-65-1.
- d. An entity within the scope of (c) shall provide the applicable transition disclosures required by Topic 250 on accounting changes and error corrections, except for the requirements in paragraphs 250-10-50-1(b)(2) and 250-10-50-3. An entity that elects the transition method in (c)(3) shall provide the transition disclosures in paragraph 250-10-50-1(b)(3) as of the beginning of the earliest period presented but not before the date on which the pending content that links to paragraph 842-10-65-1 was adopted.

## **55 Implementation Guidance and Illustrations**

### **General**

- > Implementation Guidance
- > Illustrations of Transition
- • > Illustration of Lessee Transition—Existing Capital Lease

**55-243** Example 28 illustrates lessee accounting for the transition of existing capital leases when an entity elects the transition method in paragraph 842-10-65-1(c)(1).

• • • > 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).

• • > Illustration of Lessee Transition—Existing Operating Lease

**55-248** 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).

• • • > 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.

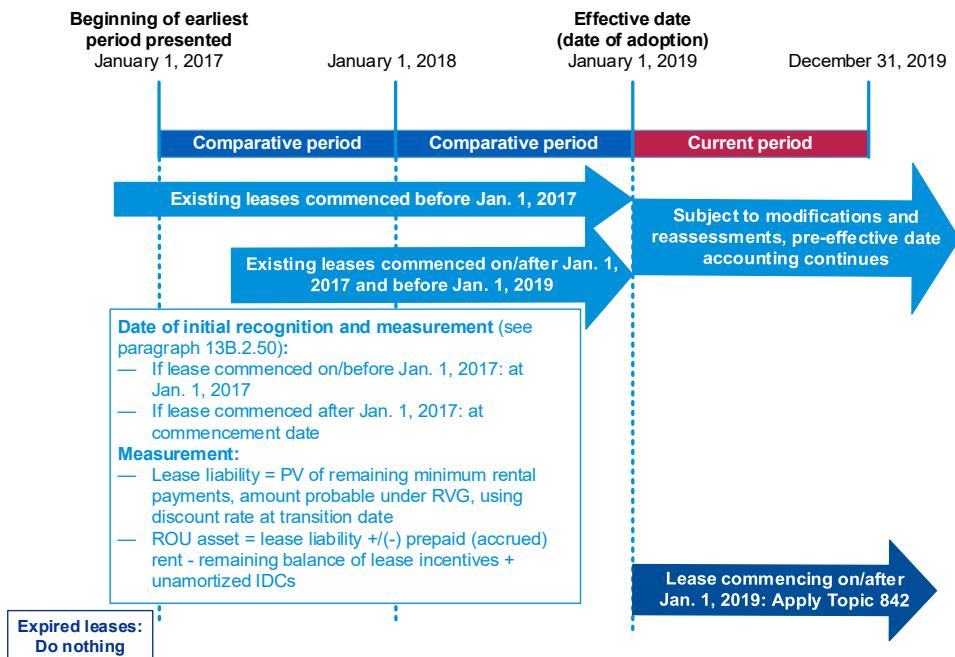
### 13B.3.1 Lessee elects package of practical expedients

13B.3.10 This section discusses the transition requirements for a lessee that elects the package of practical expedients (see section 13B.2.3). Because lease classification is not reassessed in applying the package of practical expedients: [842-10-65-1(f)(2)]

- all existing leases classified as operating leases under Topic 840 will be classified as operating leases under Topic 842; and
- all existing leases classified as capital leases under Topic 840 will be classified as finance leases under Topic 842.

#### ***Operating leases under Topic 840***

13B.3.20 The following diagram gives an overview of the transition requirements for an operating lease, which are explained in this section, assuming a public business entity with a calendar year-end.



### Lease liability initial and subsequent measurement

13B.3.30 Absent lease modifications or remeasurements, the lease liability is measured as follows, both at the transition date (see paragraph 13B.2.50) and subsequently – i.e. for the remainder of the lease term. [842-10-65-1(l)]

$$\text{Lease liability} = \text{PV of unpaid minimum rental payments}^1 + \text{PV of amount probable of being owed under RVG}$$

Note:

- Minimum rental payments (as defined in Topic 840, see Question 13B.3.10).

13B.3.40 The discount rate for the lease is measured as follows at the transition date. [842-10-65-1(l), 842-20-30-3]

- For all entities, it is the rate implicit in the lease if that rate is readily determinable (see Question 5.6.20).
- If the rate implicit in the lease is not readily determinable:
  - for public business entities, it is the lessee's incremental borrowing rate (see Question 13B.3.50);
  - for all other entities, a risk-free discount rate may be used instead of the lessee's incremental borrowing rate if the lessee elects to do so for the applicable class of underlying asset (see paragraph 5.6.30).



### Question 13B.3.10 Minimum rental payments

**Do the 'minimum rental payments' in Topic 840 exclude the portion of fixed rental payments attributable to executory costs such as taxes, insurance and maintenance (including CAM)?**

**Interpretive response:** Topic 840 is not clear in this respect. 'Minimum rental payments' is not a defined term in Topic 840 (or the ASC Master Glossary), and there has been diversity in practice.

Some entities accounted for executory costs, when part of the fixed payments in the lease contract, as part of the minimum rental payments for a lease (Approach A), while other entities excluded such amounts from the minimum rental payments (Approach B). For example, in a gross real estate lease, entities following Approach A treated the entire gross periodic payment as a minimum rental payment (and included that amount in their operating lease maturity analysis disclosure), while those following Approach B excluded the portion of the payment that represented executory costs for property taxes, insurance and maintenance from the minimum rental payments for the lease (and excluded that amount from their operating lease maturity analysis disclosure).

For any lease that includes fixed executory costs, the resulting lease liability and ROU asset will be larger measured on the basis of Approach A than they would be (i.e. assuming the same terms and conditions) measured on the basis of Approach B, and will also be larger than they would be on the basis of the 'lease payments' as defined in Topic 842 if there were non-lease components.

The SEC staff has observed "that the term 'minimum rental payments' is not explicitly defined in ASC 840. As a result, the staff did not object to registrants consistently applying their historical accounting policy conclusions regarding the composition of minimum lease payments when concluding whether executory costs should be included in remaining minimum rental payments for purposes of establishing the lease liability in transition." Consequently, a lessee's application of Approach A or Approach B under Topic 840 may be retained by the lessee when measuring its existing operating leases on transition to Topic 842 in accordance with paragraph 842-10-65-1(l). [\[2017 AICPA conf\]](#)

An entity's approach (A or B) should be disclosed and applied consistently to all of the entity's existing leases that were operating leases under Topic 840.

#### Changing from one approach to the other

In mid-2018, the SEC staff additionally communicated that changing one's approach to include or exclude executory costs from 'minimum rental payments' (e.g. changing from Approach A to Approach B) constitutes a change in accounting principle under Topic 250 (accounting changes and error corrections) that must be justified as preferable. [\[250-10-20, 250-10-45-1 – 45-2\]](#)

However, we believe it may be acceptable to switch from Approach B to Approach A without establishing preferability if that change accompanies the lessee's policy election not to separate lease and non-lease components in

transition to Topic 842 (see Question 13B.5.10). This is because in that case, the inclusion of executory costs in the measurement of the lease liability in transition is the result of the lessee electing a new accounting principle created by the issuance of ASU 2016-02, rather than changing an existing accounting principle; this scenario was not considered by the SEC staff. [250-10-45-2(a)]



### Question 13B.3.20 **Excluding CAM costs**

**Is it acceptable to exclude only the CAM portion of the 'executory' costs of a lease from the minimum rental payments in transition to Topic 842?**

**Background:** As discussed in Question 13B.3.10, it is acceptable under Topic 840 to either include or exclude executory costs from 'minimum rental payments'. Executory costs include costs of taxes, insurance and maintenance (including CAM). Topic 840 does not differentiate between these types of executory costs. [840-10-25-1]

**Interpretive response:** No. Based on discussions with the SEC staff, we do not believe the transition guidance in Topic 842 permits an approach that would solely exclude executory costs of maintenance from the minimum rental payments used to measure existing leases on transition.



### Question 13B.3.30 **Measurement of lease payments that depend on an index or rate in determining the operating lease liability**

**For operating leases with variable lease payments that depend on an index or rate and for which lease inception was before the date of initial application, what index or rate should the lessee use to measure the transition date lease liability?**

**Background:** Topic 840 states, "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 therefore affect the determination of income as accrueable." [840-10-25-4]

In practice, some entities followed this guidance when making their operating lease disclosures under Topic 840. That is, they continued to measure lease payments that depend on an index or rate (e.g. in disclosing remaining minimum rental payments in accordance with paragraph 840-20-50-2) using the

index or rate at lease inception (or the date of the last lease modification that required the entity to reassess classification of the lease) throughout the lease term. However, other entities followed a policy of updating the reference index or rate used to measure lease payments that depend on an index or rate in making their disclosure of future minimum rental payments for operating leases.

**Interpretive response:** Based on discussions with the SEC staff, we understand that the staff would accept an entity continuing its historical accounting policy with respect to using (or not using) updated indices or rates in disclosing its operating lease future minimum rental payments when measuring the transition date lease liability. This would mean:

- An entity that has historically *not* updated reference indices or rates when measuring lease payments that depend on an index or rate to include in the minimum rental payments would follow Approach A outlined below.
- An entity that has historically updated reference indices or rates when measuring lease payments that depend on an index or rate to include in the minimum rental payments would follow Approach B outlined below.

#### **Approach A: Use index or rate indicated by paragraph 840-10-25-4**

Under this approach, regardless of whether the existing operating lease is classified as an operating or a finance lease on transition, the lessee uses the index or rate (e.g. CPI) as of lease inception (or the date of the last lease modification that required the entity to reassess the classification of the lease under Topic 840, if applicable) to determine the amount of variable lease payments that depend on an index or rate to include in the transition date lease liability.

#### **Leases acquired in a business combination**

As an exception to the above, if an existing operating lease was acquired in a business combination, we believe a lessee should use the index or rate as of the later of:

- the acquisition date; or
- the date of the last lease modification that, in accordance with Topic 840, required the lessee to account for the modified lease as a new lease.

#### **Approach B: Use index or rate as of the transition date**

Under this approach, the lessee uses the index or rate (e.g. CPI) as of the transition date to determine the amount of variable lease payments that depend on an index or rate to include in the transition date lease liability.

#### **Changing approach**

An entity that has historically not updated reference indices or rates used to measure lease payments that depend on an index or rate when preparing its operating lease future minimum rental payments disclosure may want to apply Approach B.

The SEC staff has communicated that this would constitute a change in accounting principle under Topic 250 (accounting changes and error corrections) that must be justified as preferable, if material. [250-10-20, 250-10-45-1 – 45-2]

### Non-SEC registrants

We believe the above response applies equally to SEC registrants and entities that are not SEC registrants.



#### Question 13B.3.40

#### **Foreign exchange rate to use in transition when the lease is not denominated in the entity's functional currency**

**For leases with payments that are not in the lessee's functional currency that commenced before the date of initial application, what exchange rate should be used to translate the ROU asset?**

**Background:** The ROU asset for any lease (finance or operating) is a nonmonetary asset while the lease liability is a monetary liability. Therefore, 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 ROU asset is remeasured using the exchange rate as of the lease commencement date. [\[842-20-55-10\]](#)

For any capital lease under Topic 840 that commenced before the date of initial application, and that is classified as a finance lease under Topic 842, the lessee recognizes at the date of initial application a finance lease ROU asset and a finance lease liability at the carrying amount of the capital lease asset and the capital lease obligation in accordance with Topic 840 immediately before the date of initial application. [\[842-10-65-1\(r\)\(1\)\]](#)

**Interpretive response:** For any lease liability (finance or operating), it is clear the exchange rate that should be used to translate the lease liability at the date of initial application is the current rate at that date. This is because, as a monetary liability, a lease liability is always remeasured using the current exchange rate.

For a finance lease ROU asset arising from a capital lease under Topic 840, the lessee will remeasure the ROU asset at the date of initial application using the same exchange rate used immediately before that date (see background). This is because the lessee is required to recognize the finance lease ROU asset at the carrying amount of the capital lease asset, and changing the exchange rate would change the carrying amount of the ROU asset in the entity's reporting currency.

While not explicit related to leases transition, we believe the ROU asset for a finance or operating lease that was classified as an operating lease under Topic 840 should be measured in the currency of the lease first. Then that amount should be remeasured into the entity's functional currency using the rate at the date of initial application. This is because there is guidance in Topic 830 (foreign currency matters) that requires an entity to use the exchange rate on the date that an asset or liability is initially recognized. And before the date of initial application, no ROU asset was recognized. Initial recognition of

ROU assets arising from existing operating leases occurs at the date of initial application for a lease that commenced before that date. [830-20-30-1]

See section 6.4.3 for discussion of the exchange rates to be used after initial measurement for an operating lease with payments denominated in a foreign currency.



### Question 13B.3.50

#### Determining the incremental borrowing rate in transition

**For an existing operating lease that commenced before the date of initial application, should the incremental borrowing rate for that lease consider (1) the remaining lease term and remaining minimum rental payments or (2) the total lease term and total minimum rental payments?**

**Background:** Topic 842 specifies that the discount rate for each existing operating lease should be established at the transition date, which means based on the facts and circumstances (e.g. economic environment and lessee credit standing) as of that date. However, it does not prescribe whether that rate should be based on the remaining lease term and remaining minimum rental payments or the total lease term and total minimum rental payments.

**Interpretive response:** Because Topic 842 is not clear on this question, we believe either approach is acceptable, as long as it is applied consistently as an accounting policy election to all of the lessee's leases in transition and the policy disclosed. This position was affirmed by the FASB and SEC staffs, the latter in a speech by Michael P. Berrigan, Professional Accounting Fellow, Office of the Chief Accountant, at the 2017 AICPA Conference on Current SEC and PCAOB Developments.

That said, we believe use of the total lease term and total minimum rental payments may be more consistent with the intent of the Board. This is because it is our understanding that the Board's decision to permit lessees to determine the incremental borrowing rate for an existing operating lease as of the date of initial application, rather than as of lease inception or lease commencement, was a practical accommodation intended to make it easier for lessees to make an estimate they generally did not have to make in accounting for those leases under Topic 840. For example, the Board considered that it might be difficult for a lessee to get third-party information about interest rates as of a date significantly in the past – e.g. obtain a bank quote for a rate the bank would have charged 10 or 15 years ago. In contrast, it would generally be no more difficult to obtain the total lease term and total minimum rental payments than to obtain the remaining lease term and remaining minimum rental payments.

Further, we do not believe the transition provision was intended to substantially change the substance of the implied borrowing. A date of initial application discount rate based on the remaining term of the lease and the remaining minimum rental payments may differ substantially from the rate that would be determined based on the total lease term and the total lease payments. A

discount rate for the lease based on the remaining payments and term may not reflect the economics of the lease and may be inconsistent with the Board's intent that the incremental borrowing rate serve as a practical proxy for the interest rate in the contract. For example, an entity would presumably pay a very different interest rate for a 15-year loan with a principal balance of \$15 million (i.e. assume a 15-year lease term with \$15 million in gross minimum rental payments) than it would for a three-year loan with a beginning principal balance of \$3 million (i.e. a three-year lease with \$3 million in gross minimum rental payments).

### **ROU asset initial measurement**

13B.3.50 The ROU asset is measured as follows at the transition date. Section 13B.9 addresses additional considerations if the lease was acquired in a business combination. [842-10-65-1(m)]



13B.3.60 Before the amendments in ASU 2016-02, lessees were sometimes required to recognize a liability under Topic 420 (exit or disposal cost obligations) for (1) costs to terminate an operating lease before the end of its term, and/or (2) other costs associated with the operating lease that will continue to be incurred without economic benefit to the entity.

13B.3.70 At the transition date for a lease, any existing Topic 420 liability reduces the initial measurement of the ROU asset recognized for the lease regardless of whether the lease is classified as an operating lease or as a finance lease under Topic 842. If the lease is an operating lease, the accounting after the transition date is different from other operating leases. The ROU asset is generally amortized on a straight-line basis. The combined straight-line amortization of the ROU asset and the accretion of the lease liability on an effective interest basis each period is recognized as a single operating lease cost for the lease. [842-10-65-1(m) – 65-1(n)]

### **ROU asset subsequent measurement**

13B.3.80 After initial recognition, the ROU asset is measured using the same lessee subsequent measurement guidance applicable to new operating leases that commence on or after the effective date (see section 6.4.2). [842-10-65-1(n)]



### Question 13B.3.60

#### **ROU asset abandoned before the date of initial application**

**Should a lessee recognize a right-of-use (ROU) asset on transition if it has already abandoned the asset before the date of initial application?**

**Background:** A lessee may have abandoned an ROU asset (see Question 6.5.50) arising from an existing operating lease before the date of initial application. Despite this, following the transition requirements for the initial measurement of the ROU asset could result in the lessee recognizing the abandoned ROU asset. This is because the transition guidance does not address abandoned ROU asset scenarios and derives the ROU asset for existing operating leases from the lease liability (which will not be zero, even in an abandonment scenario).

**Interpretive response:** No. An ROU asset should not be recognized on transition if it was abandoned before the date of initial application. If an abandoned ROU asset is measured on transition at an amount greater than zero after applying the transition guidance, a further adjustment should be recorded through equity to reduce the carrying amount of that ROU asset to zero as of the transition date.



### Question 13B.3.70

#### **Executory costs that are part of Topic 420 liabilities on transition**

**Are amounts for lessee executory costs (e.g. property taxes) in a Topic 420 liability netted against the ROU asset established on transition?**

**Background:** Before transition to Topic 842, Lessee LE provided legal notice that it will terminate its operating lease of a facility before the conclusion of the contract term.

Based on the terms of the lease contract, in addition to making fixed rental payments, LE is required to make variable property tax payments. Under Topic 420, at the cease-use date, LE recognized a liability for the remaining rental payments and the property tax payments it expected to make over the remaining term for which it will receive no economic benefit.

**Interpretive response:** Yes. Paragraph 842-10-65-1(m) does not envisage separation of a Topic 420 operating lease liability into components – e.g. a component associated with the contractual rental payments and a component related to one or more executory costs, such as an obligation to pay property taxes on the underlying asset. Therefore, the entire Topic 420 liability is netted against the transition date ROU asset, including any portion attributable to expected executory costs for which the lessee will receive no

economic benefit, as long as the carrying amount of the ROU asset will not be reduced below zero subsequent to that action (see Question 13B.3.80).



### Question 13B.3.80

#### Transition guidance for Topic 420 liabilities results in negative ROU asset carrying amount

**If netting the existing Topic 420 liability on transition would result in a negative initial measurement of the ROU asset, how is that excess credit accounted for?**

**Background:** The carrying amount of a lessee's Topic 420 liability immediately before the Topic 842 transition date for an existing operating lease may exceed the amount that will be recognized for the lease liability at that date.

Consequently, measuring the ROU asset in accordance with paragraph 842-10-65-1(m) may result in a negative amount.

For example, the Topic 420 liability might include estimated executory costs (e.g. for property taxes or insurance) that the lessee expects to pay over the remaining lease term for which it will receive no economic benefit. However, the lease liability does not include such amounts – either because the costs are variable or because the lessee has historically followed Approach B to Question 13B.3.10.

**Interpretive response:** If netting the Topic 420 liability would create a negative ROU asset carrying amount, we believe the lessee should reduce the carrying amount of the ROU asset to zero and then do one of the following with the remaining amount of the Topic 420 liability.

- **Derecognize the 'excess' Topic 420 liability.** The corresponding entry is an adjustment to equity at the transition date. The costs underlying that excess amount will be recognized through the income statement as they are incurred after the transition date.

Under this approach, the lessee will recognize those costs through the income statement twice: once when the Topic 420 liability was established before the transition date, and again when those costs are actually incurred after the transition date. Operating lease costs are no longer in the scope of Topic 420 from the effective date of Topic 842; therefore, this approach takes the perspective that there is no longer a basis in Topic 420 to recognize the excess amounts.

Proponents of this approach believe that paragraph 842-10-65-1(d) would instruct the lessee to take the excess credit to equity on the transition date and account for the lease-related costs underlying that excess liability that will be incurred after the transition date in the same manner as such costs will be accounted for after the effective date for new leases. [842-10-65-1(d)]

- **Continue to recognize the 'excess' Topic 420 liability.** Under this approach, the excess credit is accounted for after the transition date in the same manner as before the transition date.

Proponents of this approach note that the FASB stated its intent for lessees to be able to 'run off' existing leases in accordance with the requirements in previous GAAP (other than recognizing new ROU assets and lease liabilities for existing operating leases) – see paragraph 13B.2.120.

Therefore, it would be inconsistent with that intent to require a lessee to derecognize the excess Topic 420 liability and recognize those costs through the income statement a second time. Proponents further note that it would appear to be inconsistent with the intent of the new standard to *derecognize* existing liabilities when its principal goal was the recognition of previously unrecognized lease liabilities. [IASU 2016-02.Summary, ASU 2016-02.BC390]

Topic 842 does not provide guidance on this type of scenario; therefore, in the absence of additional guidance from the FASB or the SEC staff, we believe either of the above approaches is acceptable as an accounting policy election applied to all of the entity's leases for which it is a lessee.



### Question 13B.3.90 Existing sublease liabilities under Topic 840

## How should sublease liabilities recognized under Topic 840 for existing leases be accounted for on initial application of Topic 842?

**Background:** Under Topic 840, if costs expected to be incurred under an operating sublease (e.g. executory costs and either amortization of the leased asset or rental payments on an operating lease) exceed anticipated revenue on the operating sublease, a loss is recognized by the sublessor. [840-20-25-15]

The transition guidance in Topic 842 provides explicit guidance on how to account for existing Topic 420 liabilities in transition (see paragraph 13B.3.70 and Question 13B.3.80), but does not address sublease liabilities recognized in accordance with the Topic 840 guidance in the preceding paragraph.

### Interpretive response:

#### Existing operating leases

For existing operating leases, regardless of how classified under Topic 842 (i.e. as operating or finance leases), we believe any of the following approaches is acceptable as an accounting policy election applied to all of an entity's leases for which it is the lessee.

- **By analogy to transition for Topic 420 liabilities (Topic 420 analogy approach).** Net existing sublease liabilities against the ROU asset for existing operating leases on initial application of Topic 842 by analogy to the guidance on Topic 420 liabilities in paragraph 842-10-65-1(m).

Proponents of this approach believe these two types of liabilities are similar in nature and note that the FASB staff has, in discussions about impairment of ROU assets in transition (see Question 13B.3.110, for example), also equated these two types of liabilities. Therefore, because Topic 842 does

not provide any guidance on accounting for sublease liabilities recognized under paragraph 840-20-25-15 on initial application of Topic 842, we believe analogizing to the Topic 420 liability transition guidance is reasonable.

A lessee applying this analogy will apply the guidance in *both* paragraphs 842-10-65-1(m) and 65-1(n). See paragraph 13B.3.70 and Questions 13B.3.70 and 13B.3.80.

— **Eliminate the sublease liability through equity (elimination approach).**

Write off the existing sublease liability through equity as part of the cumulative effect transition adjustment at the transition date. Topic 842 does not have sublease loss guidance like what existed in Topic 840. Therefore, proponents of this approach believe there is no longer a basis in Topic 842 upon which to continue to recognize the sublease liability. Proponents of this approach believe that paragraph 842-10-65-1(d) would instruct the lessee to write off the liability to equity at the transition date. [842-10-65-1(d)]

A lessee adopting this approach would consider whether the loss-making sublease means the newly recognized ROU asset is impaired (if the ROU asset is the only asset in its asset group). We believe at the point in time the sublease was entered into, the ROU asset may have become its own asset group (see Question 6.5.60); and if so, recognizing any impairment of the ROU asset that exists as a result of entering into the loss-making sublease through transition date equity would not conflict with the responses to Questions 13B.3.110 and 13B.3.120. However, if a Topic 360 impairment is not taken on the effective date, the effect of this approach will be that the sublease loss is taken against current period earnings after the effective date – i.e. the sublease loss recognized previously under Topic 840 will be taken a second time through earnings in periods post-adoption.

In the case of an impairment resulting from this approach, we believe the lessee's accounting on and after the transition date may be very similar in result to applying the Topic 420 analogy approach. If there is not an impairment of the ROU asset, we believe it may be unlikely that a lessee will elect this approach given the requirement to effectively recognize the sublease loss twice.

— **Retain separate recognition of the sublease liability (separate recognition approach).** The lessee would:

- continue to recognize the Topic 840 sublease liability separate from the new lease liability recognized in transition; and
- reduce the liability over the shorter of (1) the remaining head lease term or (2) the remaining term of the loss-making sublease, in a pattern consistent with the recognition of lease cost (operating leases) or amortization of the ROU asset (finance leases) over that same period of time.

In contrast to the Topic 420 analogy approach, a lessee electing this approach will not recognize the effect of the sublease loss over the entire head lease term if the sublease term is shorter than that of the head lease. Additionally, head lease cost will continue to be recognized on a straight-line basis after the transition date, rather than on a front-loaded basis as would occur if analogizing to the Topic 420 liability requirements.

Proponents of this approach note that the FASB stated its intent for lessees to be able to 'run off' existing leases in accordance with the requirements in previous GAAP (other than recognizing new ROU assets and lease liabilities for existing operating leases) – see paragraph 13B.2.120, and that this approach would be consistent with that intent. [IASU 2016-02.Summary, ASU 2016-02.BC390](#)

Under this approach, if the lease is modified or remeasured on or after the effective date, we believe the run-off allowance would end. Therefore, the remaining carrying amount of the sublease liability would be written off. We believe the offsetting entry would be first to the modified or remeasured ROU asset (dr. sublease liability, cr. ROU asset); and second to a gain. That is, a gain should only result if the adjustment would reduce the carrying amount of the ROU asset below zero. This accounting would be the most consistent with the generally prospective accounting under Topic 842 for lease modifications and remeasurements.

### **Existing capital leases classified as finance leases under Topic 842**

The transition guidance in Topic 842 for existing capital leases classified as finance leases under Topic 842 requires the new finance lease ROU asset and finance lease liability to equal the carrying amount of the existing capital lease asset and capital lease obligation. We believe this explicit requirement precludes reducing the carrying amount of the existing capital lease asset by the amount of any Topic 840 sublease liability. [\[842-10-65-1\(r\)\]](#)

Consequently, we believe a lessee is required to adopt either the 'separate recognition' or 'elimination' approaches outlined for existing operating leases.

If applying the elimination approach, we believe the requirement to measure the finance lease ROU asset at the carrying amount of the prior capital lease asset precludes recognizing an additional Topic 360 impairment as part of the transition date cumulative effect adjustment.

If applying the separate recognition approach, the lessee will:

- continue to recognize the separate Topic 840 sublease liability; and
- reduce the liability over the shorter of the (1) remaining head lease term or (2) remaining term of the loss-making sublease, in a pattern consistent with the pattern of amortization of the ROU asset over that same period of time.

### **Existing capital leases classified as operating leases under Topic 842**

For existing capital leases classified as operating leases under Topic 842, we believe the lessee should follow the 'elimination approach'. This is because the goal of the transition requirements for these leases is to effectively reset the lease so that the accounting at and after the transition date is consistent with that for any new operating lease that commences on or after the effective date (see paragraphs 13B.3.200 – 13B.3.230). To that end, we believe any new operating lease subject to a loss-making sublease will be considered for impairment under Topic 360 (see section 6.5.2); and if the ROU asset is not impaired, the lessee will account for the sublease income deficits through earnings each period as incurred.



### Question 13B.3.100

#### Accounting for foreign currency gains/losses during transition

### Should foreign currency gains and losses arising from the recognition of new ROU assets and lease liabilities be recognized in the income statement during the transition period or as a cumulative adjustment to equity?

**Background:** Lessee LE is a public business entity in the United States and has a calendar year-end. Functional and reporting currency is USD for LE. LE regularly leases equipment with payments in JPY. LE has analyzed the documentation and concluded there is not an embedded derivative in the contract.

LE adopts Topic 842 on January 1, 2019. As a part of the adoption, LE records an ROU asset and lease liability as of January 1, 2017 for its leases denominated in JPY (see Question 13B.3.40). There would be a foreign currency effect related to these leases during 2017 and 2018 because the leases are not denominated in LE's functional/reporting currency.

**Interpretive response:** Foreign currency gains and losses arising from the recognition of new ROU assets and lease liabilities should be recognized in the income statement during the transition period. There are no specific transition provisions included in Topic 842 for the accounting for foreign currency gains and losses in the comparative periods under the modified retrospective approach.

In the absence of specific transition provisions, an entity should apply the general modified retrospective transition guidance in paragraph 842-10-65-1(d), "An entity shall adjust equity at the beginning of the earliest comparative period presented, and the other comparative amounts disclosed for each prior period presented in the financial statements, as if the pending content that links to this paragraph had always been applied, subject to the requirements in (h) through (ee)."

Therefore, LE (as an example) would:

- adjust its 2017 and 2018 income statements to reflect the applicable foreign currency gains and losses; and
- adjust equity as of the beginning of January 1, 2017 (i.e. the beginning of the earliest comparative period presented) for foreign currency gains and losses related to periods before that date.



### Question 13B.3.110

#### **Effects of Topic 360 impairments before the effective date**

### **When does a lessee begin to apply the long-lived asset impairment guidance in Topic 360 to its operating lease ROU assets?**

**Interpretive response:** On the effective date of Topic 842, unless the circumstances discussed in Question 13B.3.130 exist.

At a November 2016 FASB meeting, the Board affirmed the view expressed by the FASB staff that lessees should not begin applying the long-lived asset impairment requirements in Topic 360 (property, plant, and equipment) to new ROU assets until the effective date of Topic 842. This includes ROU assets that are part of an asset group that was previously impaired, except as discussed in Questions 13B.3.90 and 13B.3.130. Even though a new ROU asset may be recognized as of the date of initial application, from that date until the effective date, those ROU assets generally should not be subject to the Topic 360 impairment guidance.

The FASB staff believes it was the Board's intent that, in general, lessees should only adjust the carrying amount of operating lease ROU assets for the following, both of which were applicable to operating leases under Topic 840:

- any liabilities recognized in accordance with the contract termination costs guidance in Topic 420; or
- the sublease guidance in paragraph 840-20-25-15. However, see Question 13B.3.90 for sublease liabilities recognized under paragraph 840-20-25-15; we do not believe offsetting of those liabilities against the ROU asset is *required*.

The Board did not intend for lessees to have to go back in time and evaluate what effect operating lease ROU assets would have had on Topic 360 impairment assessments before or during the transition period (see Question 13B.3.120).



### Question 13B.3.120

#### **Transition impact on prior asset group impairments**

### **Should a lessee's prior accounting for a long-lived asset subject to impairment under Topic 360 be changed as a result of the transition to Topic 842?**

**Background:** The recognition of operating lease ROU assets will increase the number and carrying amount of the long-lived assets in the asset group.

For example, an asset group with 50 long-lived assets that have an aggregate carrying amount of \$1 million at the date a previous asset group impairment

was recorded may have had 65 long-lived assets with an aggregate carrying amount of \$1.2 million if the operating lease ROU assets had been recognized in the past. This may have affected either or both:

- the amount of the impairment that was recorded – e.g. the amount of the impairment may have been limited to the amount that would reduce the carrying amount of the long-lived assets in the group to zero; if additional long-lived assets (ROU assets) were in the asset group, the impairment charge may have been greater (see Question 13B.3.130).
- the allocation of the impairment to the long-lived assets in the asset group – i.e. even if the total amount of the impairment did not change, the amount of impairment allocated to each asset in the group would differ if there were additional assets in the group.

**Interpretive response:** No. At a November 2016 FASB meeting, the Board affirmed the view expressed by the FASB staff that lessees should not alter their previous accounting for long-lived assets as a result of transitioning to Topic 842.

This means that impairment amounts previously allocated to a long-lived asset (e.g. an item of property, plant or equipment or a finite-lived intangible asset), and subsequent accounting resulting from the amount of that impairment (e.g. depreciation or amortization of the long-lived asset), should not be changed as a result of initially applying Topic 842.



### Question 13B.3.130 Recognizing 'hidden' ROU asset impairments on transition

#### Can a 'hidden' impairment of an ROU asset arising from a Topic 840 operating lease be recognized through equity at the date of initial application (or in the comparative periods)?

**Background:** A 'hidden impairment' refers to either:

- where a Topic 360 asset group was fully impaired before the effective date (i.e. all of the long-lived assets in the group were written down by the maximum allowable amount under Topic 360 at the time of the impairment) and an additional impairment charge would have been recorded on that asset group before the effective date had the operating lease ROU asset(s) been recognized at that date; or
- where a Topic 360 asset group would have included only one or more ROU assets that were not recognized under Topic 840, and an impairment charge would have been recorded on that asset group before the effective date had the operating lease ROU asset(s) been recognized under Topic 840.

**Interpretive response:** Based on the FASB staff views outlined in Questions 13B.3.110 and 13B.3.120, we believe it would be acceptable for a lessee not to consider the impairment guidance in Topic 360 until the effective date of Topic 842 and to recognize any impairment that exists as of that date,

including any ‘hidden impairment’, and regardless of whether the condition or event giving rise to that impairment occurred before the effective date, as a charge to adoption-year income or loss.

However, the FASB staff has expressed the view that it would be acceptable to recognize a hidden impairment of an ROU asset arising from an existing operating lease in transition. In that case, the amount of the additional impairment would be taken as of the later of the date of initial application (through an adjustment to equity) and the impairment date (through a charge to income of the comparative period the impairment was recorded), with a corresponding reduction to the carrying amount(s) of the ROU asset(s). Note that no amount of past hidden impairment should be taken at the date of initial application if the asset group to which the ROU asset belongs is not impaired based on a Topic 360 analysis at the effective date.

We believe this interpretation does not conflict with the responses to Questions 13B.3.110 and 13B.3.120 because (1) it would not affect any prior accounting for other long-lived assets and (2) reflects a unique circumstance where this adjustment is effectively the result of a past impairment assessment and preexisting conditions of impairment, rather than one triggered primarily by the recognition of new operating lease ROU assets.



### Question 13B.3.140

#### **Amortization period for leasehold improvements previously acquired in a business combination**

#### **What amortization period should a lessee assign in transition to leasehold improvements previously acquired in a business combination?**

**Background:** Topic 840 required the amortization period at the acquisition date to be the shorter of (1) the remaining useful life of the leasehold improvements and (2) *a period equal to the sum of the non-cancellable period of the lease plus renewal periods reasonably assured of exercise.* [840-10-35-9]

##### **ASC 840-10-35-9**

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 lease term) at the date of acquisition.

Topic 842 requires the amortization period at the acquisition date to be the shorter of the (1) remaining useful life of the leasehold improvements and (2) *remaining lease term.* [842-20-35-13]

Although Topic 842 and Topic 840 use different words, the amortization period for acquired leasehold improvements that results from applying both Topics is the same – i.e. one that is the shorter of (1) their remaining useful life and (2) a

period that includes the non-cancellable period of the lease plus renewal periods the acquirer is reasonably certain to exercise.

- Topic 840 used its particular *italicized* language because, before the adoption of Topic 842, an acquirer did not reassess the acquiree's lease term as part of acquisition accounting.
- In contrast, Topic 842 refers to the 'remaining lease term' because the acquirer *does* reassess the lease term of an acquired lease, as if it was a new lease of the acquirer, at the acquisition date. [805-20-30-24]

Because Topic 840 did not reassess the lease term of an acquired lease, the remaining lease term at the acquisition date could be shorter than the amortization period for the acquired leasehold improvements. This cannot occur under Topic 842.

### **Background example**

Company AR acquired Lessee LE in a business combination on January 1, 2018 – before AR's adoption of Topic 842 on January 1, 2019 – with the following facts.

- LE is the lessee in a building lease with a remaining lease term of three years immediately before the acquisition. The lease includes two five-year lessee renewal options that LE determined it was not reasonably assured to exercise; therefore, the options were excluded from LE's determination of the lease term. The lease does not include an option for LE to purchase the building.
- LE has constructed leasehold improvements, which it owns, that have a 15-year remaining useful life at the acquisition date.
- The following applied in AR's acquisition accounting for the acquired lease when Topic 840 was in effect.
  - AR did not reassess the lease term determined by LE.
  - AR concluded that the leasehold improvements should be amortized over a period of eight years from the acquisition date. Eight years includes the three-year remaining non-cancellable period of the lease plus the first of the five-year lessee renewal options, for which AR concluded exercise was reasonably assured upon acquisition. Despite the longer useful life of the leasehold improvements, AR concluded that exercise of the second five-year renewal option was not reasonably assured at the acquisition date.
- At the effective date of January 1, 2019, AR concludes that it is reasonably certain to exercise both five-year renewal options if it elects the use-of-hindsight practical expedient (see section 13B.2).

**Interpretive response:** We believe the response to this question differs depending on whether the entity elects the use-of-hindsight practical expedient.

### **Entity does not elect to use hindsight**

In general, we believe transition provisions are designed to migrate an entity's legacy accounting to that which would exist had the entity been applying the new guidance all along.

Applying this logic to the background example, had AR been applying Topic 842's requirements at the acquisition date, it would have concluded, just as it did under Topic 840, that the amortization period for the acquired leasehold improvements was eight years. This is because AR would have concluded that the remaining lease term, assessed as if the acquired lease was a new lease on the acquisition date, was eight years. Eight years is shorter than the 15-year remaining useful life of the leasehold improvements, so eight years would have been the amortization period.

Because Topic 842 and Topic 840 would result in the same amortization period, and AR did not elect to use hindsight in transition, AR simply retains the eight-year amortization period in transition to Topic 842 (seven years remaining at the effective date).

Further, this approach also considers the Board's stated intent for lessees to, in effect, have the option to 'run off' existing leases in accordance with the requirements of previous GAAP – other than recognizing new ROU assets and lease liabilities for existing operating leases (see paragraph 13B.2.120). This approach, which retains the entity's amortization period for the leasehold improvements in transition, is consistent with that intent. [IASU 2016-02.Summary, ASU 2016-02.BC390](#)

### **Entity elects to use hindsight**

Again using the background example, if AR elected the use-of-hindsight practical expedient in transition, AR would account for the acquired lease in transition as if it had always (since the acquisition date) assessed the lease term as 13 years (rather than eight years).

In contrast to an entity that does not elect hindsight, we believe an entity electing to use hindsight is also deciding to abandon 'running off' its old lease accounting. An entity electing hindsight is choosing to reassess, rather than continue to use, legacy accounting judgments such as the lease term.

Therefore, we believe AR would also adjust the amortization period of the acquired leasehold improvements – i.e. AR would adjust its accounting for those leasehold improvements, including in its comparative financial statements for periods before its Topic 842 adoption, as if it had originally assigned a 13-year amortization period to those improvements (rather than eight years). This will result in a reduction to 2018 amortization expense, resulting in an increased carrying amount for the leasehold improvements as of the effective date.

### **Post-transition accounting for acquired leasehold improvements**

Regardless of whether it elected the use-of-hindsight practical expedient in transition, after transition an acquirer will change the amortization period for acquired leasehold improvements if either:

- the lease term changes – through either reassessment or modification (not accounted for as a separate contract) – if the remaining lease term is the amortization period under paragraph 842-20-35-12; or
- the useful life of the leasehold improvements changes and the remaining useful life is (or becomes, as a result of a decrease to the useful life) the amortization period under paragraph 842-20-35-12.

In that case, the change in amortization period is accounted for prospectively in accordance with Topic 250 (accounting changes and error corrections). [250-10-45-17 – 45-20]



### Example 13B.3.10

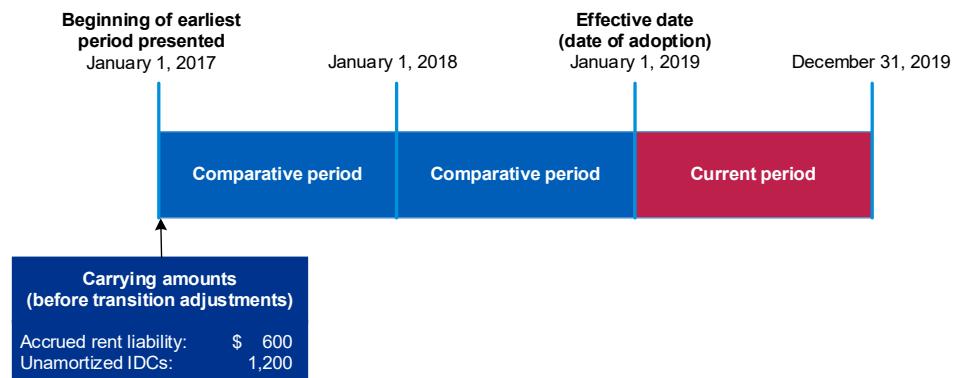
#### Lessee transition for an existing operating lease with package of practical expedients elected – Approach A in Question 13B.3.10

##### Scenario 1: Lease is not modified or remeasured on or after the effective date

The following summarizes relevant information about Lessee LE's lease of office space.

Commencement date of the lease:	January 1, 2016
Lease term:	5 years
Rental payments (annual, paid in arrears), which represent the minimum rental payments under Topic 840: <sup>1</sup>	\$28,000 first two years, \$29,000 thereafter
Estimated amount of annual payments related to reimbursing the lessor's costs of property taxes, insurance, and CAM that are <i>included</i> in the above minimum rental payments: <sup>1</sup>	\$1,500 property taxes \$1,000 insurance \$1,000 CAM
Lease classification at inception under Topic 840:	Operating lease
Initial direct costs, amortized on a straight-line basis over the lease term:	\$1,500
Note:	
1.	In this example, LE has <b>included</b> fixed executory costs in the minimum rental payments when applying Topic 840 and is consistently applying this policy in transition – i.e. LE has applied Approach A discussed in Question 13B.3.10.

#### Effective date and transition



Because LE elected the package of practical expedients, it does not reassess whether the contract is or contains a lease, whether classification of the lease

would be different under Topic 842, or whether the unamortized initial direct costs at January 1, 2017 would meet the definition of initial direct costs under Topic 842.

### **Worksheet at January 1, 2017 (beginning of earliest period presented)**

At January 1, 2017, LE's incremental borrowing rate is 5.0% (see section 5.6 and Question 13B.3.50).

Step	Amounts debit/(credit)	Notes
Recognize lease liability	\$101,880	Remaining minimum rental payments (\$28,000 for 2017 and \$29,000 for each of 2018–2020) discounted at 5.0%
Recognize ROU asset	102,480	Sum of lease liability recognized and \$1,200 of unamortized IDCs, less \$600 accrued rent liability
Derecognize accrued rent	600	Balance at transition under Topic 840
Derecognize unamortized IDCs	(1,200)	Balance at transition under Topic 840
<b>Adjustment to equity</b>	<b>\$ -</b>	N/A

### **Subsequent accounting for the lease**

LE subsequently measures the lease liability and ROU asset through the end of the lease term in a manner similar to how it determined the lease liability and ROU asset at January 1, 2017; unless the lease is modified or there is a remeasurement of the lease liability.

LE does not modify the lease and does not have to remeasure the lease liability on or after the effective date. There is also no impairment of the ROU asset through the remainder of the lease term.

### **Balance sheet**

LE recognizes the following amounts in its balance sheet for its lease of office space through the end of the lease term.

Year ended	ROU asset arising from operating lease	Lease liability arising from operating lease
Dec. 31, 2018 <sup>1</sup>	\$53,723	\$53,923
Dec. 31, 2019	27,519	27,619
Dec. 31, 2020	-	-

Note:

- The December 31, 2017 balance sheet is not shown because it is expected that LE will present only one comparative balance sheet (i.e. as of December 31, 2018) in its first set of financial statements issued after the effective date of Topic 842.

### **Income statement<sup>1</sup>**

LE recognizes the following amounts in its income statement for its lease of office space through the end of the lease term.

Year ended	Operating lease cost
Dec. 31, 2017	\$28,900 <sup>2</sup>
Dec. 31, 2018	28,900
Dec. 31, 2019	28,900
Dec. 31, 2020	28,900

Notes:

1. A lessee continues to present lease cost in a manner consistent with its presentation under Topic 840 (e.g. SG&A expenses).
2. \$28,600 (total minimum rental payments of \$143,000 / 5 years) + \$300 (amortization of initial direct costs of \$1,500 / 5 years).

### **Scenario 2: Lease is modified after the effective date**

Changing the facts of Scenario 1, on January 1, 2020 LE modifies the lease to extend the lease term for two additional years. The original lease agreement did not include any renewal options.

As a result, LE applies the lease accounting guidance under Topic 842 beginning on the effective date of the modification (January 1, 2020). Because the modification increases the lease term only, it does not grant LE an additional right of use, and therefore the modification cannot be accounted for as a separate contract. Accordingly, LE adjusts the original lease liability and records an equal and offsetting change to the existing ROU asset. The following summarizes relevant information for the remeasurement of the lease liability.

Extension period:	2 years
Remaining lease term, including the extension:	3 years
Annual, fixed payments during extension period of 2 years (paid in arrears):	\$30,000
Fixed payment for the remaining 1 year of the original lease term (paid in arrears):	\$29,000
Estimated amount of the remaining annual payments related to reimbursing the lessor's costs of property taxes, insurance and CAM:	\$1,750 property taxes \$1,000 insurance \$1,050 CAM
Additional initial direct costs associated with the lease modification:	None

At the effective date of the modification, \$300 of the initial direct costs from the initial lease remain unamortized.

### **Lease liability remeasurement**

In this example, LE identifies only one difference between Topic 840 and Topic 842 that affects the remeasurement of the lease liability and the ROU asset.

- Under Topic 840 (if applying Approach A in Question 13B.3.10), the minimum rental payments (which are used to measure the lease liability and the ROU asset before the modification) included fixed amounts that were intended to reimburse the lessor's costs of property taxes, insurance and CAM. There were no non-lease components under Topic 840.
- Under Topic 842, CAM is a non-lease component (a non-lease service provided to LE by LR). Fixed payments required by the contract are allocated between the lease component (i.e. the right to use the asset) and the non-lease component (CAM) on a relative stand-alone price basis. Therefore, a portion of what LE accounted for as the 'minimum rental payments' under Topic 840 (i.e. the fixed payments attributable to CAM) will not be part of the 'lease payments' for the modified lease under Topic 842. Assume that this allocation is 95% to the lease component and 5% to CAM.

LE remeasures the lease liability based on:

- one remaining lease payment of \$27,550 (for the remainder of the original lease term), which is 95% of the total fixed payment; the remaining 5% (\$1,450) is allocated to the CAM non-lease component; and
- two additional lease payments of \$28,500 for the extension period, which is 95% of the total fixed payment; the remaining 5% (\$1,500) is allocated to the CAM non-lease component.

LE discounts the lease payments at its January 1, 2020 incremental borrowing rate of 5.5%. This results in a remeasured lease liability of \$75,991, or an increase of \$48,372 compared to the lease liability balance immediately before the effective date of the modification.

### Journal entry

LE records the following journal entry at the effective date of the modification.

	<i>Debit</i>	<i>Credit</i>
ROU asset	48,372	
Lease liability		48,372
<i>To remeasure ROU asset and lease liability following lease modification.</i>		

### Lease classification

LE reassesses lease classification as of the effective date of the modification and determines that the modified lease is still classified as an operating lease. This reassessment is based on facts and circumstances at that date – e.g. the remaining economic life and fair value of the underlying asset at that date.

### Subsequent accounting for the lease

LE calculates the remaining lease cost for the lease as follows.

Total lease payments (including those paid and those not yet paid), reflecting the adjustment resulting from the lease modification	
12/31/16    12/31/17    12/31/18    12/31/19    12/31/20    12/31/21    12/31/22	
\$28,000    \$28,000    \$29,000    \$29,000    \$27,550    \$28,500    \$28,500	\$198,550
Plus: Total initial direct costs attributable to the lease	1,500
Less: Periodic lease cost recognized in prior periods calculated as (straight-line rental expense of $\$28,600 \times 4$ periods) plus (amortization of initial direct costs of \$1,200)	(115,600)
<b>Remaining lease cost for the lease</b>	<b>\$ 84,450</b>

LE recognizes a single lease cost, calculated so that the remaining cost of the lease is allocated over the remaining lease term on a straight-line basis (i.e. \$28,150 per year for the remaining three years).

LE prospectively accounts for the lease liability and ROU asset from the effective date of the modification using the guidance in Topic 842 for an operating lease.

### Balance sheet

LE recognizes the following amounts in its balance sheet for its lease of equipment through the end of the revised lease term.

Year ended	ROU asset arising from operating lease	Lease liability arising from operating lease
Dec. 31, 2020	\$51,921	\$52,620
Dec. 31, 2021	26,665	27,014
Dec. 31, 2022	-	-

### Income statement<sup>1</sup>

LE recognizes the following amounts in its income statement for its lease of office space through the end of the lease term.

Year ended	Operating lease cost
Dec. 31, 2020	\$28,150
Dec. 31, 2021	28,150
Dec. 31, 2022	28,150
Note:	
1. A lessee continues to present lease cost in a manner consistent with its presentation under Topic 840 (e.g. SG&A expenses).	



### Example 13B.3.20

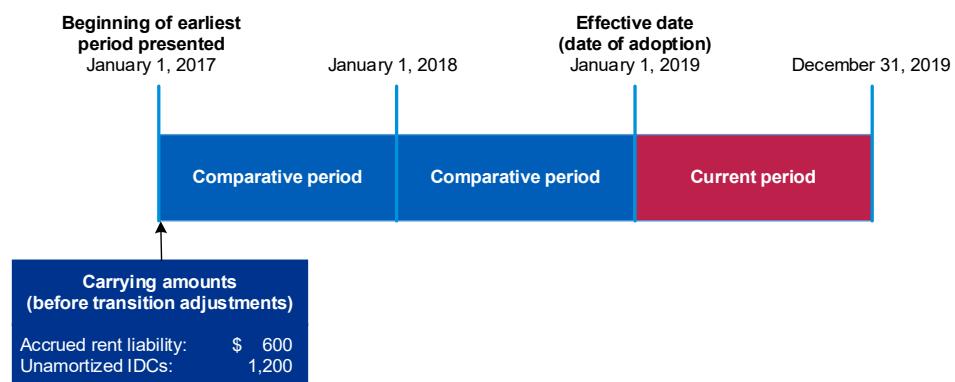
#### **Lessee transition for an existing operating lease with package of practical expedients elected – Approach B in Question 13B.3.10**

##### **Scenario 1: Lease is not modified or remeasured on or after the effective date**

The following summarizes relevant information about Lessee LE's lease of office space.

Commencement date of the lease:	January 1, 2016
Lease term:	5 years
Rental payments (annual, paid in arrears):	\$28,000 first two years, \$29,000 thereafter
Estimated amount of annual payments related to reimbursing the lessor's costs of property taxes, insurance, and CAM that are included in the above rental payments:	\$1,500 property taxes \$1,000 insurance \$1,000 CAM
Minimum rental payments under Topic 840: <sup>1</sup>	\$24,500 first two years, \$25,500 thereafter
Lease classification at inception under Topic 840:	Operating lease
Initial direct costs, amortized on a straight-line basis over the lease term:	\$1,500
Note:	
1.	In this example, LE has <i>excluded</i> fixed executory costs from the minimum rental payments when applying Topic 840 and is consistently applying this policy in transition – i.e. LE has applied Approach B discussed in Question 13B.3.10.

#### **Effective date and transition**



Because LE elected the package of practical expedients, it does not reassess whether the contract is or contains a lease, whether classification of the lease would be different under Topic 842, or whether the unamortized initial direct costs at January 1, 2017 would meet the definition of initial direct costs under Topic 842.

### Worksheet at January 1, 2017 (beginning of earliest period presented)

At January 1, 2017, LE's incremental borrowing rate is 5.0% (see section 5.6 and Question 13B.3.50).

Step	Amounts debit/(credit)	Notes
Recognize lease liability	\$(89,469)	Remaining minimum rental payments (\$24,500 for 2017 and \$25,500 for each of 2018–2020) discounted at 5.0%
Recognize ROU asset	90,069	Sum of lease liability recognized and \$1,200 of unamortized IDCs, less \$600 accrued rent liability
Derecognize accrued rent	600	Balance at transition under Topic 840
Derecognize unamortized IDCs	(1,200)	Balance at transition under Topic 840
<b>Adjustment to equity</b>	<b>\$ -</b>	N/A

### Subsequent accounting for the lease

LE subsequently measures the lease liability and ROU asset through the end of the lease term in a manner similar to how it determined the lease liability and ROU asset at January 1, 2017; unless the lease is modified or there is a remeasurement of the lease liability.

LE does not modify the lease and does not have to remeasure the lease liability on or after the effective date. There is also no impairment of the ROU asset through the remainder of the lease term.

### Balance sheet

LE recognizes the following amounts in its balance sheet for its lease of office space through the end of the lease term.

Year ended	ROU asset arising from operating lease	Lease liability arising from operating lease
Dec. 31, 2018 <sup>1</sup>	\$47,214	\$47,414
Dec. 31, 2019	24,185	24,285
Dec. 31, 2020	-	-

Note:

- The December 31, 2017 balance sheet is not shown because it is expected that LE will present only one comparative balance sheet (i.e. as of December 31, 2018) in its first set of financial statements issued after the effective date of Topic 842.

### Income statement<sup>1</sup>

LE recognizes the following amounts in its income statement for its lease of office space through the end of the lease term.

Year ended	Operating lease cost
Dec. 31, 2017	\$25,400 <sup>2</sup>
Dec. 31, 2018	25,400

Year ended	Operating lease cost
Dec. 31, 2019	25,400
Dec. 31, 2020	25,400

Notes:

1. A lessee continues to present lease cost in a manner consistent with its presentation under Topic 840 (e.g. SG&A expenses).
2. \$25,100 (total minimum rental payments of \$125,500 / 5 years) + \$300 (amortization of initial direct costs of \$1,500 / 5 years).

### Scenario 2: Lease is modified after the effective date

Changing the facts of Scenario 1, on January 1, 2020 LE modifies the lease to extend the lease term for two additional years. The original lease agreement did not include any renewal options.

As a result, LE applies the lease accounting guidance under Topic 842 beginning on the effective date of the modification (January 1, 2020). Because the modification increases the lease term only, it does not grant LE an additional right of use, and therefore the modification cannot be accounted for as a separate contract. Accordingly, LE adjusts the original lease liability and records an equal and offsetting change to the existing ROU asset. The following summarizes relevant information for the remeasurement of the lease liability.

Extension period:	2 years
Remaining lease term, including the extension:	3 years
Annual, fixed payments during extension period of 2 years (paid in arrears):	\$30,000
Fixed payment for the remaining 1 year of the original lease term (paid in arrears):	\$29,000
Estimated amount of the remaining annual payments related to reimbursing the lessor's costs of property taxes, insurance and CAM:	\$1,750 property taxes \$1,000 insurance \$1,050 CAM
Additional initial direct costs associated with the lease modification:	None

At the effective date of the modification, \$300 of the initial direct costs remain unamortized.

### Lease liability remeasurement

In this example, LE identifies only one difference between Topic 840 and Topic 842 that affects the remeasurement of the lease liability and the ROU asset:

- Under Topic 840 (if applying Approach B in Question 13B.3.10), the minimum rental payments (which are used to measure the lease liability and the ROU asset before the modification) excluded fixed amounts that were intended to reimburse the lessor's costs of property taxes, insurance and CAM, while the 'lease payments' under Topic 842 generally include at

least a portion of such amounts. There were no non-lease components of this contract under Topic 840.

- Under Topic 842, the CAM is a non-lease component (a non-lease service provided to LE by LR). Fixed payments required by the contract are allocated between the lease component (i.e. the right to use the asset) and the non-lease component (CAM) on a relative stand-alone price basis. Therefore, the portion of the consideration in the contract attributable to CAM will not be part of the 'lease payments' for the modified lease under Topic 842. Assume that this allocation is 95% to the lease component and 5% to CAM.

LE remeasures the lease liability based on:

- one remaining lease payment of \$27,550 (for the remainder of the original lease term), which is 95% of the total fixed payment; the remaining 5% (\$1,450) is allocated to the CAM non-lease component; and
- two additional lease payments of \$28,500 for the extension period, which is 95% of the total fixed payment; the remaining 5% (\$1,500) is allocated to the CAM non-lease component.

LE discounts the lease payments at its January 1, 2020 incremental borrowing rate of 5.5%. This results in a remeasured lease liability of \$75,991, or an increase of \$51,706 compared to the lease liability balance immediately before the effective date of the modification.

### Journal entry

LE records the following journal entry at the effective date of the modification.

	Debit	Credit
ROU asset	51,706	
Lease liability		51,706
<i>To remeasure ROU asset and lease liability following lease modification.</i>		

### Lease classification

LE reassesses lease classification as of the effective date of the modification and determines that the modified lease is still classified as an operating lease.

### Subsequent accounting for the lease

LE calculates the remaining lease cost for the lease as follows.

Total lease payments (including those paid and those not yet paid), reflecting the adjustment resulting from the lease modification	
12/31/16    12/31/17    12/31/18    12/31/19    12/31/20    12/31/21    12/31/22	
\$24,500    \$24,500    \$25,500    \$25,500    \$27,550    \$28,500    \$28,500	\$184,550
Plus: Total initial direct costs attributable to the lease	1,500
Less: Periodic lease cost recognized in prior periods calculated as (straight-line rental expense of $\$25,100 \times 4$ periods) plus (amortization of initial direct costs of \$1,200)	(101,600)
<b>Remaining lease cost for the lease</b>	<b>\$ 84,450</b>

LE recognizes a single lease cost, calculated so that the remaining cost of the lease is allocated over the remaining lease term on a straight-line basis (i.e. \$28,150 per year for the remaining three years).

LE prospectively accounts for the lease liability and ROU asset from the effective date of the modification using the guidance in Topic 842 for an operating lease.

### **Balance sheet**

LE recognizes the following amounts in its balance sheet for its lease of equipment through the end of the revised lease term.

<b>Year ended</b>	<b>ROU asset arising from operating lease</b>	<b>Lease liability arising from operating lease</b>
Dec. 31, 2020	\$51,921	\$52,620
Dec. 31, 2021	26,665	27,014
Dec. 31, 2022	-	-

### **Income statement<sup>1</sup>**

LE recognizes the following amounts in its income statement for its lease of office space through the end of the lease term.

<b>Year ended</b>	<b>Operating lease cost</b>
Dec. 31, 2020	\$28,150
Dec. 31, 2021	28,150
Dec. 31, 2022	28,150

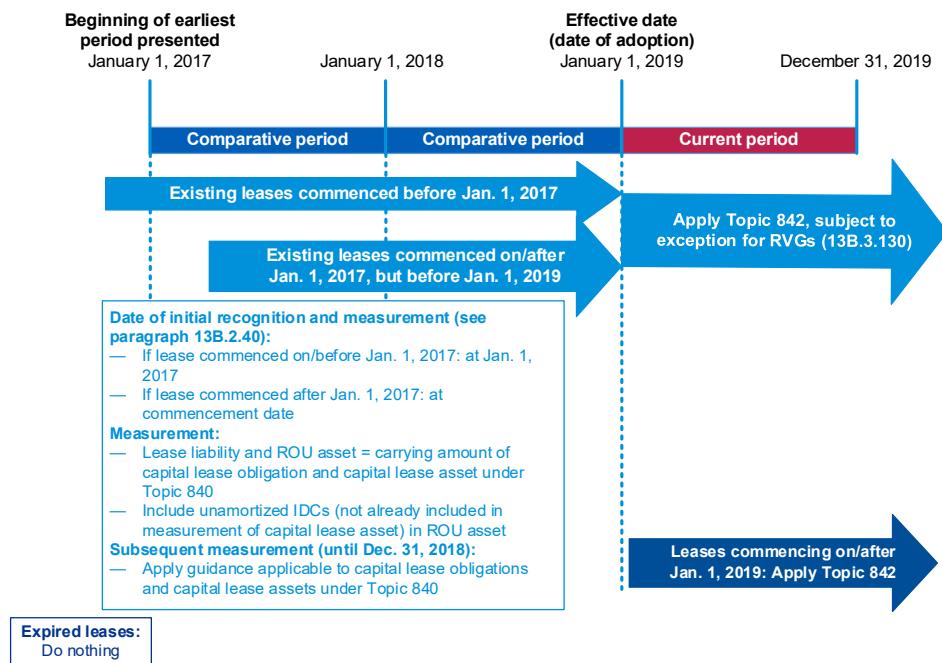
Note:

1. A lessee continues to present lease cost in a manner consistent with its presentation under Topic 840 (e.g. SG&A expenses).

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### **Capital leases under Topic 840**

13B.3.90 The following diagram gives an overview of the transition requirements for a capital lease, which is explained in this section, assuming a public business entity with a calendar year-end.



## Initial recognition and measurement

13B.3.100 The lease liability and ROU asset are initially measured as follows at the transition date (see paragraph 13B.2.50). [842-10-65-1(r)(1) – 65-1(r)(2)]

Topic 842 item	Measurement
<b>Lease liability</b>	— Carrying amount of capital lease obligation under Topic 840 immediately before the transition date.
<b>ROU asset</b>	— Carrying amount of the capital lease asset under Topic 840 immediately before the transition date. — Plus any unamortized initial direct costs not included in the capital lease asset under Topic 840.

## Subsequent measurement for periods before the effective date

13B.3.110 A lessee subsequently measures the ROU asset and the lease liability in accordance with the subsequent measurement guidance in Topic 840. [842-10-65-1(r)(4)]

## Subsequent measurement beginning on the effective date

13B.3.120 A lessee measures the ROU asset and the lease liability in accordance with the subsequent measurement guidance applicable to new finance leases under Topic 842.

13B.3.130 As an exception, a lessee does not remeasure the lease payments for changes in amounts probable of being owed under residual value guarantees unless the lease liability is remeasured for other reasons – e.g. because of a change in the lease term or in the assessment of a lessee purchase option. [842-10-65-1(r)(5)]

## Presentation and disclosure

13B.3.140 A lessee presents the assets and liabilities under capital leases as ROU assets and lease liabilities arising from finance leases for presentation and disclosure purposes in all periods presented in the financial statements.  
[842-10-65-1(r)(6)]



### Example 13B.3.30

#### Lessee transition for an existing capital lease with package of practical expedients elected

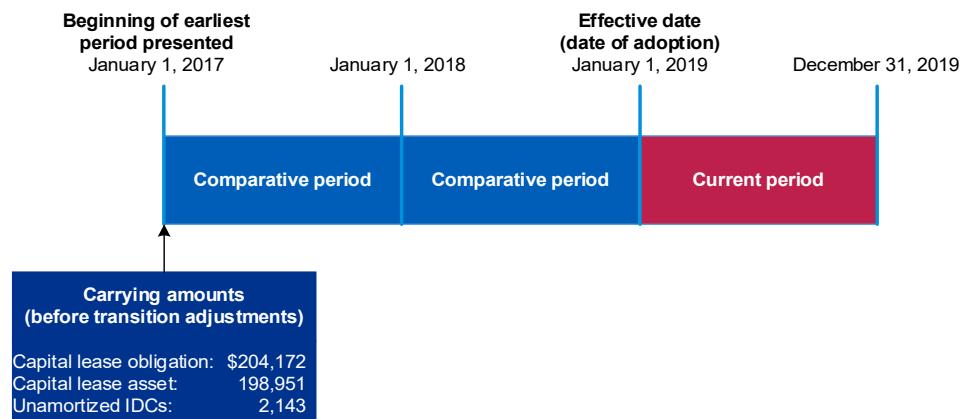
##### Scenario 1: Lease is not modified or remeasured on or after the effective date

###### About the lease

The following summarizes relevant information about Lessee LE's lease of equipment.

Commencement date of the lease:	January 1, 2016
Lease term:	7 years
Lease payments (annual, paid in arrears):	\$40,000
Residual value guarantee (lessee):	\$6,000
Amount probable of being owed under the residual value guarantee (no change throughout lease term):	\$2,000
Lease classification at inception under Topic 840:	Capital lease
LE's incremental borrowing rate at lease inception:	5.5%
Initial direct costs, amortized on a straight-line basis over the lease term:	\$2,500

###### Effective date and transition



LE elects the package of practical expedients. Therefore, LE does not reassess whether the contract is or contains a lease, whether classification of the lease would be different under Topic 842, or whether the unamortized initial direct

costs at January 1, 2017 would meet the definition of initial direct costs under Topic 842.

**Worksheet at January 1, 2017 (beginning of earliest period presented)**

Step	Amounts debit/(credit)	Notes
Recognize lease liability	\$(204,172)	Equal to existing capital lease obligation
Recognize ROU asset	201,094	Equal to existing capital lease asset (\$198,951) + existing unamortized IDCs (\$2,143)
<b>Adjustment to equity</b>	<b>\$</b>	- N/A – replacing existing assets and liabilities at the same amounts

**Subsequent accounting for the lease**

LE will account for the lease liability and ROU asset in accordance with the subsequent measurement guidance:

- in Topic 840 through December 31, 2018; and
- in Topic 842 from January 1, 2019 through the end of the lease term. However, as an exception, because the entire amount of the \$6,000 residual value guarantee is already included in the lease liability, LE will not make any adjustments for changes in the amount that it is probable of owing under the residual value guarantee.

LE does not modify the lease or have to remeasure the lease liability (e.g. for a change in the lease term) subsequent to the effective date. The following tables show the effect of the lease accounting on the financial statements.

**Balance sheet**

LE recognizes the following amounts in its balance sheet through the end of the lease term.

Year ended	ROU asset arising from finance lease	Lease liability arising from finance lease
Dec. 31, 2018 <sup>1</sup>	\$135,396	\$145,048
Dec. 31, 2019	102,547	113,026
Dec. 31, 2020	69,698	79,242
Dec. 31, 2021	36,849	43,601
Dec. 31, 2022	4,000	6,000

Note:

1. The December 31, 2017 balance sheet is not shown because it is expected that LE will present only one comparative balance sheet (i.e. as of December 31, 2018) in its first set of financial statements issued after the effective date of Topic 842. We expect that many lessees will present their finance lease ROU assets and finance lease liabilities in the same balance sheet line item as they presented capital lease assets and capital lease obligations under Topic 840.

At the end of the lease term, LE makes a payment under the residual value guarantee and credits cash for \$2,000, debits the lease liability for \$6,000 and credits the ROU asset for \$4,000.

#### *Income statement<sup>1</sup>*

LE recognizes the following amounts in its income statement through the end of the lease term.

Year ended	Interest expense	Amortization of ROU assets
Dec. 31, 2017	\$11,229	\$32,849
Dec. 31, 2018	9,647	32,849
Dec. 31, 2019	7,978	32,849
Dec. 31, 2020	6,216	32,849
Dec. 31, 2021	4,359	32,849
Dec. 31, 2022	2,399	32,849

Note:

1. The interest expense on the lease liability and amortization of the ROU asset are not required to be presented as separate line items; rather each is presented in a manner consistent with how the entity presents other interest expense and depreciation or amortization of similar assets (see section 6.9).

#### **Scenario 2: Lease liability is remeasured after the effective date**

Changing the facts of Scenario 1, on January 1, 2020, LE remeasures the lease liability. The lease included a renewal option and LE now determines that it is reasonably certain to exercise the option based on the occurrence of a significant event that is within its control (see section 6.6).

As a result, LE applies the lease accounting guidance under Topic 842 beginning on the remeasurement date (January 1, 2020). The following summarizes relevant information for the remeasurement of the lease liability.

Renewal period:	3 years
Remaining lease term:	6 years
Lease payments for the renewal period (annual, paid in arrears):	\$43,000
Lease payments for the remainder of the original lease term (annual, paid in arrears):	\$40,000
Amount probable of being owed under the residual value guarantee at the end of the revised lease term:	\$ 1,500
LE's incremental borrowing rate at January 1, 2020:	6.0%

#### **Lease liability remeasurement**

In this example, LE identifies one difference between Topic 840 and Topic 842 that affects the measurement of the lease liability and the ROU asset. Under Topic 840, minimum lease payments included the full amount of a lessee residual value guarantee (and therefore the capital lease obligation and the capital lease asset reflect the full amount of such guarantee) while the definition

of lease payments under Topic 842 includes only amounts probable of being owed by the lessee to satisfy the guarantee.

LE remeasures the lease liability based on:

- three remaining payments of \$40,000 (the remainder of the original lease term);
- three additional payments of \$43,000 to reflect the renewal period; and
- a final payment of \$1,500 to satisfy the residual value guarantee.

LE discounts the stream of lease payments at its incremental borrowing rate of 6.0% at January 1, 2020. This results in a remeasured lease liability of \$204,483, or an increase of \$91,457 compared to the lease liability balance immediately before the remeasurement date.

#### **Journal entry**

LE records the following journal entry at January 1, 2020.

	Debit	Credit
ROU asset	91,457	
Lease liability		91,457
<i>To remeasure ROU asset and lease liability following reassessment of lease term.</i>		

#### **Lease classification**

LE also reassesses lease classification, concurrent with the remeasurement of the lease, based on the facts and circumstances at the remeasurement date (e.g. the fair value and remaining economic life of the underlying asset at that date) and determines that the lease is still a finance lease.

#### **Subsequent accounting for the lease**

LE prospectively accounts for the lease liability and the ROU asset using the guidance in Topic 842 for a finance lease (see section 6.4.1).

- The lease liability carrying amount is increased each period of the remaining lease term to reflect interest on the lease liability and reduced to reflect the lease payments made during the period.
- The ROU asset is measured at cost less any accumulated amortization (and any accumulated impairment losses).

#### **Balance sheet**

LE recognizes the following amounts in its balance sheet for its lease of equipment through the end of the revised lease term.

<b>Year ended</b>	<b>ROU asset arising from finance lease</b>	<b>Lease liability arising from finance lease</b>
Dec. 31, 2020	\$161,670	\$176,752
Dec. 31, 2021	129,336	147,357
Dec. 31, 2022	97,002	116,198
Dec. 31, 2023	64,668	80,170
Dec. 31, 2024	32,334	41,980
Dec. 31, 2025	-	1,500

At the end of the lease term, LE makes a payment under the residual value guarantee, debits the lease liability for \$1,500 and credits cash for \$1,500.

#### *Income statement<sup>1</sup>*

LE recognizes the following amounts in its income statement for its lease of equipment through the end of the revised lease term.

Year ended	Interest expense	Amortization of ROU asset
Dec. 31, 2020	\$12,269	\$32,334
Dec. 31, 2021	10,605	32,334
Dec. 31, 2022	8,841	32,334
Dec. 31, 2023	6,972	32,334
Dec. 31, 2024	4,810	32,334
Dec. 31, 2025	2,520	32,334

Note:

1. The interest expense on the lease liability and amortization of the ROU asset are not required to be presented as separate line items in the income statement; rather each is presented in a manner consistent with how the entity presents other interest expense and depreciation or amortization of similar assets (see section 6.9).

### **13B.3.2 Lessee does not elect package of practical expedients**

13B.3.150 Section 13B.3.1 discussed the lessee transition requirements when the lessee elects the package of practical expedients and includes Questions 13B.3.10 – 13B.3.130. Despite the inclusion of those questions in section 13B.3.1, we believe the responses to those questions do not change if the lessee does not elect the package of practical expedients or the use of hindsight practical expedient.

#### ***Leases previously classified as operating leases under Topic 840***

#### ***Leases classified as operating leases under Topic 842***

13B.3.160 In general, the recognition, initial measurement and subsequent measurement of the lease liability and ROU asset are the same as for a lessee that elects the package of practical expedients for its leases (see paragraphs 13B.3.30 – 13B.3.80). As an exception, at the transition date, any unamortized initial direct costs that do not meet the definition of initial direct costs under Topic 842 are written off as an adjustment to equity (if the costs were incurred before the beginning of the earliest period presented in the financial statements) or to earnings of the comparative period presented (if incurred on or after the beginning of the earliest period presented). This means that the initial and subsequent measurement of the lessee's ROU asset, and periodic lease cost after the transition date, will differ between a lessee that elects the package of practical expedients and one that does not for the same

lease for the effect of initial direct costs written off in transition. [842-10-65-1(k), 65-1(n), 65-1(p)]

### **Leases classified as finance leases under Topic 842**

#### **Initial recognition and measurement**

13B.3.170 The lease liability is recognized and measured the same as for an existing operating lease that remains classified as an operating lease (see paragraph 13B.3.160). [842-10-65-1(o)]

13B.3.180 The ROU asset is recognized and measured using the formula in paragraph 13B.3.50, except that the starting point is a *proportion of the original lease liability* – i.e. the lease liability as of the original commencement date that is calculated as follows.



Note:

1. Topic 842 states that this amount can be 'imputed' from the remaining lease liability, rather than directly calculated. Example 13B.3.40 demonstrates imputing the original lease liability and this is further discussed as part of the Example. [842-10-65-1(o)]

#### **Subsequent measurement**

13B.3.190 Subsequent to initial recognition and measurement, there is no difference in accounting for the finance lease in transition solely because it was previously classified as an operating lease under Topic 840 – i.e. compared with a finance lease previously classified as a capital lease under Topic 840. Example 13B.3.40 illustrates the accounting for an existing lease classified as an operating lease under Topic 840 but classified as a finance lease under Topic 842.

### **Leases previously classified as capital leases under Topic 840**

#### **Leases classified as finance leases under Topic 842**

13B.3.200 In general, the recognition, initial measurement and subsequent measurement of the lease liability and ROU asset are the same as for a lessee that elects the package of practical expedients for its leases. However, as an exception, at the transition date, any unamortized initial direct costs that do not meet the definition of initial direct costs under Topic 842 and that are not included in the measurement of the capital lease asset under Topic 840 are written off as an adjustment to equity (if incurred before the beginning of the earliest period presented in the financial statements) or to earnings of the comparative period presented (if incurred on or after the beginning of the earliest period presented). This means that the initial and subsequent measurement of the lessee's ROU assets, and amortization thereon, will differ between a lessee that elects the package of practical expedients and one that

does not for the same lease for the effect of initial direct costs written off in transition. [842-10-65-1(r), 65-1(t)]

## **Leases classified as operating leases under Topic 842**

### **Transition adjustments**

13B.3.210 At the transition date, a lessee: [842-10-65-1(s)]

- derecognizes the carrying amount of the capital lease asset and capital lease obligation determined under Topic 840; the difference is accounted for as prepaid or accrued rent; and
- writes off any unamortized initial direct costs that do not meet the definition of initial direct costs under Topic 842 as an adjustment to equity (if incurred before the beginning of the earliest period presented in the financial statements) or to earnings of the applicable comparative period presented (if incurred on or after the beginning of the earliest period presented).

### **Initial recognition and measurement**

13B.3.220 The lessee initially measures the operating lease liability and operating lease ROU asset as of the transition date, using the subsequent measurement guidance in Subtopic 842-20 if the commencement date was before the date of initial application, and the initial measurement guidance in Subtopic 842-20 if the commencement date is on or after the date of initial application. [842-10-65-1(s)(2) – 65-1(s)(3)]

### **Subsequent recognition and measurement**

13B.3.230 Subsequent to the transition date, the lessee accounts for the operating lease in the same manner as it accounts for any other operating lease under Topic 842. [842-10-65-1(s)(4)]

## Observation **Changes in lessee lease classification in transition**

13B.3.240 In general, we believe it will be relatively infrequent that a lease classified as an operating lease under Topic 840 will be classified as a finance lease under Topic 842 or vice versa. However, here are a few examples of changes in the lease classification guidance that could result in different outcomes.

- Four of the five classification tests in Topic 842 for determining if a lease is a finance lease are substantially similar to those in Topic 840 for determining if a lease is a capital lease. However, Topic 842 includes a fifth test (the 'alternative use' test – see section 6.2) that has no equivalent in Topic 840. The introduction of this test could result in some Topic 840 operating leases being classified as finance leases if reassessed under Topic 842.
- Lessees under Topic 840 do not consider either the lease term or present value classification tests (see section 6.2) when the lease term falls within the last 25 percent of the total estimated economic life of the underlying asset. Topic 842 only includes a similar exemption for the lease term test (see section 6.2). Consequently, some leases for which the present value

test in Topic 840 was not even considered would have to consider the similar present value test in Topic 842 and some of those leases might therefore be classified as finance leases.

- While Topic 842 permits entities to continue to use 75 and 90 percent as bright-line thresholds when performing the lease term and present value lease classification tests, respectively, it does not require use of those thresholds. Consequently, an entity not using those thresholds could reach a different conclusion about the classification of some of its existing leases if it reassesses lease classification under Topic 842 (see section 6.2).

13B.3.250 In the first two examples mentioned above, the result of the changes to the lease classification guidance from Topic 840 to Topic 842 is that a previously classified operating lease might be classified as a finance lease. In the third example, in theory, the effect could be that a previously classified operating lease is classified as a finance lease or vice versa; however, it appears less likely that an entity could reasonably conclude that a lease term greater than 75 percent is not a 'major part' of the remaining economic life of the underlying asset or a present value of lease payments greater than 90 percent of the fair value of the underlying asset is not 'substantially all' of the fair value of the underlying asset than the opposite. For further discussion, see Questions 6.2.10 and 6.2.20.

13B.3.260 Based on our evaluation of the guidance, we believe, to the extent some changes in lease classification would occur if a lessee were not to elect the package of practical expedients, most of those differences will be in the direction of previously classified operating leases becoming finance leases, rather than vice versa.



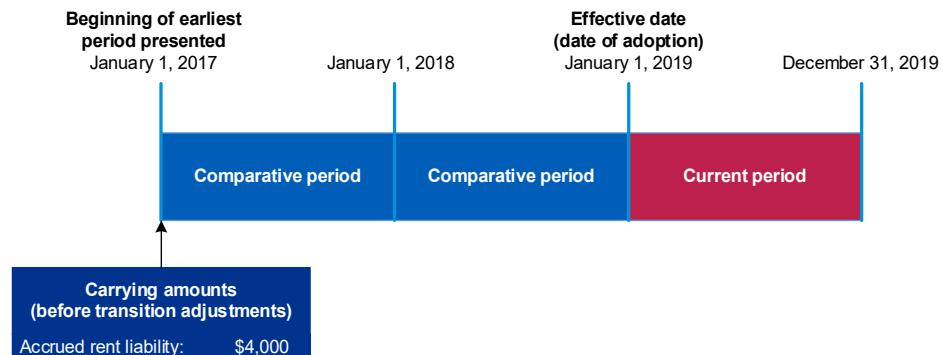
### Example 13B.3.40

#### **Lessee transition for operating lease under Topic 840 classified as a finance lease under Topic 842 – package of practical expedients not elected**

The following summarizes relevant information about Lessee LE's lease of a machine.

Commencement date of the lease:	January 1, 2015
Lease term:	6 years
Minimum rental payments determined under Topic 840 (annual, paid in arrears):	\$51,000 first 3 years \$55,000 last 3 years
Lease classification at inception under Topic 840:	Operating lease
Initial direct costs:	None

## Effective date and transition



LE does not elect the package of practical expedients available under Topic 842.

### At January 1, 2017 (beginning of earliest period presented)

Assume that the lease would have been classified as a finance lease under Topic 842 at lease commencement. At January 1, 2017, LE's incremental borrowing rate is 6% (see section 5.6 and Question 13B.3.50).

### Lease liability measurement

On January 1, 2017, LE measures the finance lease liability as \$186,807, which is the present value of one payment of \$51,000, and three payments of \$55,000, discounted at 6%.

### ROU asset measurement

LE determines the carrying amount of the ROU asset at January 1, 2017 using the formula described in Topic 842 as follows.

<b>Step 1:</b>	Determine the minimum rental payments over the remaining lease term as of the transition date: $\$51,000 + (\$55,000 \times 3) = \$216,000$
<b>Step 2:</b>	Determine the lease term at lease commencement: 6 years Assume LE does not elect the use-of-hindsight practical expedient (see Section 13B.2). Therefore, at the effective date, LE does not revisit its previous conclusion about the lease term. If LE had elected to use hindsight, the total and remaining lease term at the date of initial application would reflect LE's reevaluation as of the effective date (see Question 13B.2.40)
<b>Step 3:</b>	Determine the remaining lease term as of the transition date: 4 years
<b>Step 4:</b>	Divide the amount determined in Step 1 by the amount determined in Step 3: $\$216,000 / 4 \text{ years} = \$54,000 \text{ per year}$
<b>Step 5:</b>	Determine the present value of the periodic payment calculated in Step 4 over the lease term identified in Step 2 using the lessee's incremental borrowing rate at the transition date: \$54,000 per year in arrears for 6 years discounted at 6% = \$265,536
<b>Step 6:</b>	Multiply the amount in Step 5 by the ratio of the remaining lease term calculated in Step 3 divided by the lease term identified in Step 2: $\$265,536 \times (4 / 6) = \$177,024$
<b>Step 7:</b>	Add to the amount calculated in Step 6 the amount of any previously recognized prepaid rental payments (and subtract from that amount any accrued rental payments): $\$177,024 - \$4,000 = \$173,024$

### Journal entry

The difference between the ROU asset and the lease liability on January 1, 2017 is an adjustment to opening retained earnings at that date. Lessee LE recognizes the following journal entry to reflect the transition of the operating lease to a finance lease.

	Debit	Credit
ROU asset	173,024	
Accrued rent	4,000	
Retained earnings	9,783	
Lease liability		186,807
<i>To recognize finance lease on transition.</i>		

### Subsequent accounting for the lease

Subsequent to January 1, 2017, LE's accounting is no different from that illustrated in Example 13B.3.30, Scenario 1.

#### ***Imputing the commencement date lease liability – alternative approach***

In specifying measurement of the ROU asset as a proportion of the original lease liability (the lease liability at the commencement date), Topic 842 allows the original lease liability to be imputed from the lease liability determined at the transition date. There is no additional guidance or an example of how to do this. [\[842-10-65-1\(o\)\]](#)

The 2013 Exposure Draft included an illustrative example of how to impute the original lease liability from the transition date lease liability. The approach illustrated above imputes the original lease liability in the same manner as in the 2013 Exposure Draft. However, because the example was not carried forward to Topic 842, there may be other ways an entity could meet the requirements. In addition, in the Exposure Draft, the lease liability was not calculated based on the remaining minimum rental payments as is now required by paragraph 842-10-65-1(l).

For example, the guidance would not appear to prohibit the lessee in this example from calculating the 'original lease liability' based on the actual minimum rental payments (\$51,000 for the first three years; \$55,000 for the final three years), rather than the derived lease payments of \$54,000 illustrated. In that case:

- The original lease liability, using the 6% discount rate for the lease, would be \$259,761 (rather than \$265,536).
- The lessee would then multiply that amount (\$259,761) by the ratio of the remaining lease term calculated in Step 3 divided by the lease term identified in Step 2 ( $\$259,751 \times (4 / 6) = \$173,174$ ).
- As with the other approach, the lessee would reduce this amount (\$173,174) by the amount of the accrued rent (\$173,174 – \$4,000 = \$169,174).

Under this approach, at January 1, 2017 LE would record a slightly different journal entry than that recorded using the preceding approach.

	<i>Debit</i>	<i>Credit</i>
ROU asset	169,174	
Accrued rent	4,000	
Retained earnings	13,633	
Lease liability		186,807
<i>To recognize finance lease on transition.</i>		

### 13B.3.3 ASU 2021-09, Discount Rate for Lessees That Are Not Public Business Entities

13A.3.270 ASU 2021-09 (issued November 11, 2021) permits a lessee that is not a public business entity to use a risk-free discount rate for the lease, instead of its incremental borrowing rate, as an accounting policy election by class of underlying asset. The ASU also clarifies that a lessee must use the rate implicit in the lease when it is readily determinable even if it has elected the risk-free discount rate expedient. [842-20-30-3]

13A.4.280 The effective dates of the amendments in ASU 2021-09 are as follows. [842-10-65-6]

Effective date	Entities that adopted Topic 842 before ASU 2021-09 was issued	Entities that did not adopt Topic 842 before final ASU was issued
Annual periods – fiscal years beginning after	December 15, 2021	Adopt when the entity adopts Topic 842
Interim periods – in fiscal years beginning after	December 15, 2022	
Early adoption allowed?	Yes, as of the beginning of fiscal year	

13A.4.290 The available transition approaches depend on the entity's Topic 842 adoption status as of November 11, 2021 (i.e. the issuance date of ASU 2021-09).

- **Private entities that have not yet adopted Topic 842** will adopt the amendments in ASU 2021-09 at the same time and using the same transition method they use to adopt Topic 842 – either the effective date method or the comparative method (see chapters 13A and 13B, respectively).
- **Private entities that have already adopted Topic 842** will apply ASU 2021-09 on a modified retrospective basis to all leases that exist at the adoption date of the ASU's amendments through a cumulative effect adjustment to retained earnings at the beginning of their fiscal year.

### 13B.3.4 ASU 2023-01, Common Control Arrangements

13B.3.290 ASU 2023-01 (issued March 27, 2023) contains amendments to Topic 842 around two issues that apply to arrangements between entities under common control.

13B.3.300 The effective dates of the amendments in ASU 2023-01 are as follows.  
[842-10-65-7, 65-8]

Effective date	Issue 1 (private entities only)	Issue 2 (all entities)
Annual periods – fiscal years beginning after	December 15, 2023	December 15, 2023
Interim periods – in fiscal years beginning after	December 15, 2023	December 15, 2023
Early adoption allowed?	Yes, in any annual or interim period, as of the beginning of the fiscal year, for which financial statements have not yet been made available for issuance	
Entities that have not issued (or made available for issuance) financial statements under Topic 842 before final ASU was issued	May adopt concurrent with Topic 842	

#### Issue 1

13B.3.310 ASU 2023-01 permits a private entity to elect a practical expedient to use the written terms and conditions, as opposed to the legally enforceable terms and conditions, of a common control leasing arrangement to determine whether a lease exists and, if so, to determine the classification of and accounting for that lease. See section 3.1.2. [842-10-15-3A]

13B.3.320 The available transition approaches depend on the entity's Topic 842 adoption status as of March 27, 2023 (i.e. the issuance date of ASU 2023-01).  
[842-10-65-7]

- **Private entities that have not yet issued (or made available for issuance) financial statements under Topic 842** have the option to adopt the Issue 1 amendments in their first Topic 842 compliant financial statements and use the same transition method as they used to adopt the remainder of Topic 842 (i.e. the comparative method – for the effective date method, see chapter 13A).
- **Private entities that have already applied Topic 842 in financial statements that have been issued (or made available for issuance)** have the option to adopt the Issue 1 amendments:
  - prospectively to common control arrangements that commence or are modified on or after the entity's adoption date of the ASU (e.g. January 1, 2024 if a calendar year end entity that does not early adopt the amendments); or
  - on a modified retrospective basis to all common control arrangements that still exist at the entity's adoption date of the ASU.

Under the modified retrospective transition approach, the entity records the effect of adopting the Issue 1 amendments through a cumulative-effect adjustment to retained earnings at the beginning of the earliest period presented in the financial statements.

For example, assume that a calendar year private entity adopted Topic 842 on January 1, 2022; adopted the Issue 1 amendments on January 1, 2024; and is issuing financial statements that will present 2023 and 2024. Under this transition approach, the entity would record the required cumulative-effect adjustment as of January 1, 2023 (beginning of earliest period presented), but based on an assumed retrospective application as of January 1, 2022 (Topic 842 adoption date) to common control arrangements still in place at January 1, 2024.

## **Issue 2**

13B.3.330 The Issue 2 amendments require that a lessee in a common control lease that is the accounting owner of related leasehold improvements generally amortize the improvements over their estimated useful life to the common control group, regardless of the Topic 842 lease term, as long as it continues to control the use of the underlying asset (see section 6.4). [842-20-35-12A]

13B.3.340 The available transition approaches depend on the entity's Topic 842 adoption status as of March 27, 2023 (i.e. the issuance date of ASU 2023-01). [842-10-65-8]

- **Entities that have not yet issued (or made available for issuance) financial statements under Topic 842** have the option to adopt the Issue 2 amendments in their first Topic 842 compliant financial statements and use the same transition method as they used to adopt the remainder of Topic 842 (i.e. the comparative method – for the effective date method, see chapter 13A). Alternatively, these entities may use one of the two prospective methods outlined below for entities that have already adopted Topic 842.
- **Entities that have already applied Topic 842 in financial statements that have been issued (or made available for issuance)** have the following three options to adopt the Issue 2 amendments.
  - Prospectively to all leasehold improvements that are recognized on or after the date the entity first applies the amendments (e.g. January 1, 2024 for a calendar year entity that does not early adopt).
  - Prospectively to all new and existing leasehold improvements that are recognized on or after the date the entity first applies the amendments, with the remaining unamortized balance of existing leasehold improvements amortized over their remaining useful life to the common control group (determined as of that same date).
  - On a modified retrospective basis (i.e. to the beginning of the period in which Topic 842 is first applied – *e.g. January 1, 2022 for a calendar year private entity that did not early adopt Topic 842*) by applying the amendments to existing leasehold improvements at the Issue 2 adoption date (*e.g. January 1, 2024 for a calendar year entity that does not early adopt those amendments*), with a cumulative-effect adjustment to the opening balance of retained earnings at the beginning

of the earliest period presented (e.g. January 1, 2023 if the entity is presenting 2023 and 2024 in its financial statements) for any leasehold improvements recognized as a result of adopting the ASU.

## 13B.4 Transition for lessors



### Excerpt from ASC 842-10

#### 65 Transition and Open Effective Date Information

##### General

> Transition Related to Accounting Standards Updates No. 2016-02, *Leases (Topic 842)*, No. 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*, No. 2018-10, *Codification Improvements to Topic 842, Leases*, No. 2018-11, *Leases (Topic 842): Targeted Improvements*, No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, 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*, No. 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*, No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*, No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*, and No. 2023-01, *Leases (Topic 842): Common Control Arrangements*

**65-1** The following represents the transition and effective date information related to Accounting Standards Updates No. 2016-02, *Leases (Topic 842)*, No. 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*, No. 2018-10, *Codification Improvements to Topic 842, Leases*, No. 2018-11, *Leases (Topic 842): Targeted Improvements*, No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, 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*, No. 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*, No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*, No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*, and No. 2023-01, *Leases (Topic 842): Common Control Arrangements*: [Note: See paragraph 842-10-S65-1 for an SEC Staff Announcement on transition related to Update 2016-02.]

##### Lessors

###### Leases previously classified as operating leases under Topic 840

- 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.
- 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:
  1. Derecognize the carrying amount of the underlying asset at the application date as determined in (c).
  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.
  3. Record any difference between the amounts in (w)(1) and (w)(2) as follows:
    - 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).
    - ii. If an entity elects the transition method in (c)(2), as an adjustment to equity.
  4. Account for the lease in accordance with this Topic after the application date as determined in (c).

#### **Leases previously classified as direct financing or sales-type leases under Topic 840**

- 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).
- y. For each lease classified as an operating lease in accordance with this Topic, the objective is to account for the lease, beginning on the application date as determined in (c), as if it had always been accounted for as an operating lease in accordance with this Topic. Consequently, a lessor shall do all of the following:
  1. Recognize the underlying asset at what the carrying amount would have been had the lease been classified as an operating lease under Topic 840.
  2. Derecognize the carrying amount of the net investment in the lease.
  3. Record any difference between the amounts in (y)(1) and (y)(2) as follows:
    - 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) or earnings (if the commencement date of the lease was on or after the beginning of the earliest period presented).
    - ii. If an entity elects the transition method in (c)(2), as an adjustment to equity.
  4. Subsequently account for the operating lease in accordance with this Topic and the underlying asset in accordance with other Topics.

> Transition Related to Accounting Standards Update No. 2018-11, *Leases (Topic 842): Targeted Improvements*

**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.

> Transition Related to Accounting Standards Update No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*

**65-3** 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*:

- 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 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 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:
  1. In the first reporting period ending after the issuance of the pending content that links to this paragraph
  2. In the first reporting period beginning after the issuance of the pending content that links to this paragraph.
- 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:
  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.

> Transition 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*

**65-4** The following represents the transition and effective date information related to Accounting Standards Update 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. Early 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).

> Transition Related to Accounting Standards Update No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*

**65-5** The following represents the transition and effective date information related to Accounting Standards Update No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*:

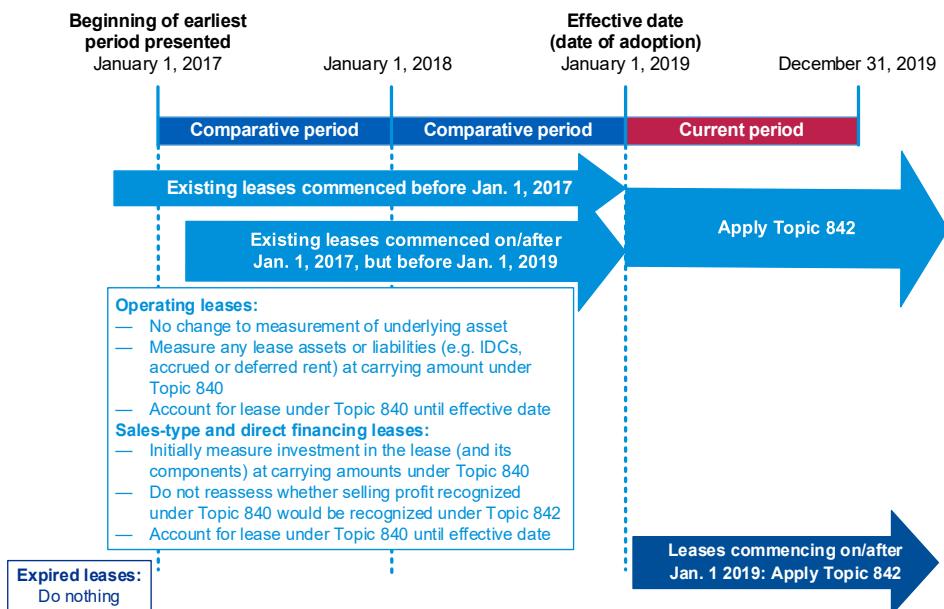
- a. An entity that has not yet adopted the pending content that links to paragraph 842-10-65-1 as of July 19, 2021, shall apply the pending content that links to this paragraph when it first applies the pending content that links to paragraph 842-10-65-1 and shall apply the same transition method elected for the pending content that links to paragraph 842-10-65-1.
- b. An entity within the scope of paragraph 842-10-65-1(a) that has adopted the pending content that links to paragraph 842-10-65-1 as of July 19, 2021, shall apply the pending content that links to this paragraph for fiscal years beginning after December 15, 2021, and interim periods within those fiscal years. Earlier application is permitted.
- c. An entity within the scope of paragraph 842-10-65-1(b) that has adopted the pending content that links to paragraph 842-10-65-1 as of July 19, 2021, shall apply the pending content that links to this paragraph for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. Earlier application is permitted.

- d. An entity within the scope of (b) or (c) shall apply the pending content that links to this paragraph by using one of the following two methods:
  - 1. Retrospectively to the date in which the pending content that links to paragraph 842-10-65-1 was adopted (the beginning of the period of adoption of Topic 842). Under this transition method, the entity shall apply the pending content that links to this paragraph to leases that commence or are modified on or after the beginning of the period of its adoption of Topic 842 and do not meet the conditions in paragraph 842-10-25-8.
  - 2. Prospectively to leases that commence or are modified on or after the date that the entity first applies the pending content that links to this paragraph and do not meet the conditions in paragraphs 842-10- 25-8.
- e. An entity within the scope of (b) or (c) that elects the transition method in (d)(1) shall provide the following transition disclosures:
  - 1. The applicable 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
  - 2. The transition disclosures in paragraph 250-10-50-1(b)(3) as of the beginning of the earliest period presented but not before the date in which the pending content that links to paragraph 842-10-65-1 was adopted.
- f. An entity within the scope of (b) or (c) that elects the transition method in (d)(2) shall provide the following transition disclosures:
  - 1. The nature of and reason for the change in accounting principle
  - 2. The transition method
  - 3. A qualitative description of the financial statement line items affected by the change.

### 13B.4.1 Lessor elects package of practical expedients

13B.4.10 The following are the transition requirements applicable to a lessor that elects the package of practical expedients. Because lease classification is not reassessed in applying the package of practical expedients: [842-10-65-1(f)(2)]

- all existing leases classified as operating leases under Topic 840 will be classified as operating leases under Topic 842; and
- all existing leases classified as sales-type or direct financing leases under Topic 840 will be classified as sales-type or direct financing leases under Topic 842.



### ***Leases previously classified as operating leases under Topic 840***

13B.4.20 At the transition date, a lessor: [842-10-65-1(v)]

- continues to recognize the underlying asset and any lease assets or liabilities (e.g. accrued or deferred rent income) at their carrying amounts recognized in accordance with Topic 840 immediately before the transition date; and
- accounts for previously recognized securitized receivables as secured borrowings in accordance with other GAAP, if applicable.

13B.4.30 After the transition date, the lessor accounts for the operating lease in accordance with Topic 840 for periods before the effective date; and starting on the effective date, in accordance with the operating lease guidance in Topic 842.

### ***Leases previously classified as sales-type or direct financing leases under Topic 840***

13B.4.40 At the transition date, a lessor continues to recognize a net investment in the lease equal to the carrying amount of the net investment immediately preceding that date; this includes any unamortized initial direct costs capitalized as part of the net investment in the lease in accordance with Topic 840. An exception arises if election of the hindsight practical expedient results in a change to the lease term or the assessment of a lessee purchase option (see Question 13B.2.50). [842-10-65-1(x)(1) – 65-1(x)(2)]

13B.4.50 After the transition date, the lessor accounts for the net investment in the lease under Topic 840 for periods before the effective date; and starting on the effective date, under the Topic 842 recognition, subsequent measurement, presentation and disclosure guidance. [842-10-65-1(x)(3)]

13B.4.60 If the lease is modified (and that modification is not accounted for as a separate contract) on or after the effective date, a lessor applies Topic 842 beginning at the modification date and accounts for the modification under the lessor modifications guidance in Topic 842. A lessor does not remeasure the net investment in the lease after the effective date unless the lease is modified (and that modification is not accounted for as a separate contract).  
[842-10-65-1(x)(4)]

## 13B.4.2 Lessor does not elect package of practical expedients

### ***Leases previously classified as operating leases under Topic 840***

#### **Leases classified as operating leases under Topic 842**

13B.4.70 The accounting at and subsequent to the transition date is the same as it is for a lessor that elects the package of practical expedients for its leases. As an exception, at the transition date, any unamortized initial direct costs that do not meet the definition of initial direct costs under Topic 842 are written off as an adjustment to equity (if incurred before the beginning of the earliest period presented in the financial statements) or to earnings of the comparative period presented (if incurred on or after the beginning of the earliest period presented).  
[842-10-65-1(v)]

#### **Leases classified as direct financing or sales-type leases under Topic 842**

13B.4.80 The objective is to account for the lease, beginning on the transition date, as if it had always been accounted for as a direct financing lease or a sales-type lease in accordance with Topic 842. Therefore, at the transition date a lessor: [842-10-65-1(w)]

- derecognizes the carrying amount of the underlying asset;
- recognizes a net investment in the lease as if the lease had been accounted for as a direct financing lease or a sales-type lease under Topic 842 since lease commencement; and
- records the difference between the carrying amount of the underlying asset derecognized and the net investment in the lease recognized as an adjustment to equity (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 section 13B.9)) or to comparative period earnings (if the commencement date of the lease was on or after the beginning of the earliest period presented).

13B.4.90 After the transition date, the lessor accounts for the lease in accordance with Topic 842. [842-10-65-1(w)(4)]

### ***Leases previously classified as direct financing or sales-type leases under Topic 840***

#### **Leases classified as direct financing or sales-type leases under Topic 842**

13B.4.100 The accounting at, and subsequent to, the transition date is the same as it is for a lessor that elects the package of practical expedients for its leases (see section 13B.4.1). [842-10-65-1(x)]

13B.4.110 Initial direct costs included in the measurement of the net investment in the lease are not written off even if they do not meet the definition of initial direct costs under Topic 842. [842-10-65-1(x)(1)]

### **Leases classified as operating leases under Topic 842**

13B.4.120 The objective is to account for the lease, beginning at the transition date, as if it had always been accounted for as an operating lease in accordance with Topic 842. Therefore, at the transition date, a lessor: [842-10-65-1(y)(1) – 65-1(y)(3)]

- derecognizes the carrying amount of the net investment in the lease;
- recognizes the underlying asset at the carrying amount that would have been recognized had the lease been classified as an operating lease under Topic 840; and
- records any difference between the carrying amount of the underlying asset recognized and the net investment in the lease derecognized as an adjustment to equity (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) or comparative period earnings (if the commencement date of the lease was on or after the beginning of the earliest period presented).

13B.4.130 A lessor subsequently accounts for the operating lease in accordance with Topic 842 and the underlying asset in accordance with other GAAP. [842-10-65-1(y)(4)]



### **Question 13B.4.10**

#### **Offset to assets and liabilities written-off on transition**

**If the classification of a lease changes on transition, is the difference between those assets and liabilities derecognized and those recognized by the lessor taken as an adjustment to equity if the lease commenced during the transition period?**

**Interpretive response:** No. A lessor should record through its transition period income statement, rather than equity, any amount(s) that would have been recognized in its income statement for the comparative periods presented had the lease always been accounted for under Topic 842. [842-10-65-1(w)(3)(i), 65-1(y)(3)(i)]



### Example 13B.4.10

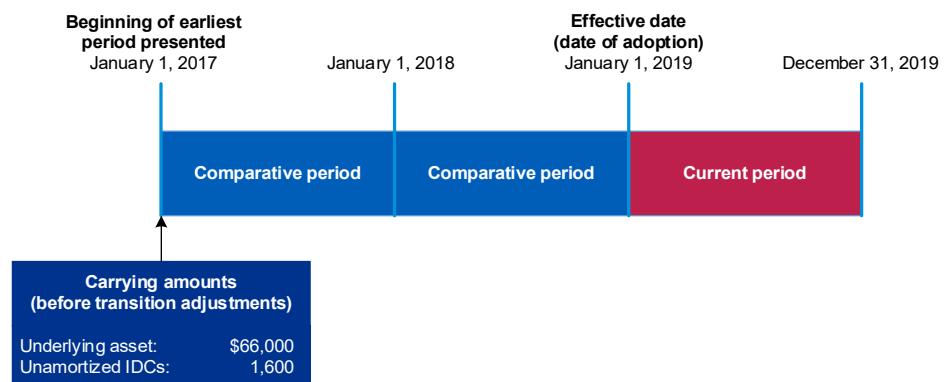
#### Lessor transition for an operating lease under Topic 840 classified as a sales-type lease under Topic 842

The following summarizes relevant information about Lessor LR's lease of equipment. In this example, LR does not elect the package of practical expedients.

Commencement date of the lease:	January 1, 2016
Lease term:	5 years
Renewal, termination or purchase options:	None
Lease payments (annual, paid in arrears):	\$17,000
Estimated residual value of the equipment at the end of the lease term:	\$18,000
Residual value guarantee (provided by either lessee or third party):	None
Fair value at January 1, 2016:	\$77,000
Carrying amount at January 1, 2016:	\$77,000
Remaining (and original) economic life of the equipment:	7 years
Useful life of the equipment:	7 years
Initial direct costs incurred by lessor under Topic 840 (only \$800 would meet the definition of initial direct costs under Topic 842):	\$2,000
Rate implicit in the lease under Topic 840, which does not factor in initial direct costs:	9.368%
Rate implicit in the lease under Topic 842 (see section 5.6):	9.01%
Lease classification at inception under Topic 840:	Operating lease

The lease is not modified on or after the effective date.

#### Effective date and transition



LR does not elect the package of practical expedients. Therefore, it reassesses whether the arrangement is or contains a lease, whether classification of the lease would be different under Topic 842, and whether the unamortized initial direct costs of \$1,600 at January 1, 2017 would have qualified for capitalization under Topic 842.

LR determines that the arrangement is still a lease. However, the lease is classified as a sales-type lease under Topic 842. Only \$800 of the \$2,000 in initial direct costs under Topic 840 meet the definition of initial direct costs under Topic 842, but that \$800 would also have been capitalized because the fair value of the underlying asset equaled its carrying amount at lease commencement.

#### **Worksheet at January 1, 2017 (beginning of earliest period presented)**

The objective of the transition guidance in this case is to account for the lease, beginning on January 1, 2017 (i.e. the transition date), as if it had always been a sales-type lease accounted for in accordance with Topic 842.

Step	Amounts debit/(credit)	Notes
Derecognize the carrying amount of the underlying asset	\$(66,000)	\$77,000 original carrying amount – 1 year of depreciation ( $\$77,000 / 7\text{-year useful life} = \$11,000$ )
Derecognize entire unamortized portion of originally capitalized IDCs	(1,600)	\$2,000 original amount of IDCs capitalized – 1 year of IDCs amortization ( $\$2,000 / 5 \text{ year lease term} = \$400$ ) <i>The portion capitalizable under Topic 842 will be included in the net investment in the sales-type lease</i>
Recognize a net investment in the lease as if the lease had been accounted for as a sales-type lease under Topic 842 since lease commencement	67,810	Commencement date net investment in the lease of \$77,800 (\$77,000 fair value of the underlying asset + \$800 in capitalizable IDCs) – 2017 lease payment of \$17,000 + 2017 interest on the net investment in the lease of \$7,010 ( $\$77,800 \times 9.01\%$ )
<b>Adjustment to equity</b>	<b>\$ (210)</b>	

Accordingly, LR records the following journal entry.

	Debit	Credit
Net investment in equipment lease	67,810	
Equipment		66,000
Unamortized initial direct costs		1,600
Retained earnings		210
<i>To recognize sales-type lease on transition.</i>		

After January 1, 2017, LR accounts for the lease in accordance with Topic 842.



#### Observation

#### **Changes in lessor lease classification in transition**

13B.4.140 Consistent with the Observation at paragraph 13B.3.240, we believe it will be relatively infrequent that a lease classified as an operating lease under Topic 840 would be classified as a sales-type or direct financing lease under

Topic 842 or vice versa. The same examples outlined in that observation could result in a different classification of an existing lease for lessors if reassessed under the classification criteria in Topic 842, most likely from classification as an operating lease under Topic 840 to classification as a sales-type lease (or, less frequently, to a direct financing lease).

13B.4.150 In addition to those examples, a lease classified as an operating lease under Topic 840 solely because either (1) collectibility of the minimum lease payments was not reasonably predictable, or (2) there were important uncertainties surrounding the amount of unreimbursable costs yet to be incurred by the lessor under the lease would be classified as a sales-type lease under Topic 842. Topic 842 does not preclude sales-type lease classification when there are collectibility uncertainties or when there are uncertainties surrounding unreimbursable costs.

13B.4.160 Consistent with our earlier lessee observations, it appears to us that, where lease classification might change for lessors if reassessed under Topic 842, it is most likely to involve operating leases being reassessed as sales-type or direct financing leases rather than the opposite.



## Observation

### **Initial direct costs included in the net investment in a sales-type or direct financing lease**

13B.4.170 If a lessor does not elect the package of practical expedients, it is required to reassess only whether those unamortized initial direct costs at the transition date capitalized in connection with an operating lease under Topic 840 would meet the definition of initial direct costs under Topic 842.

13B.4.180 Initial direct costs capitalized in connection with a direct financing lease under Topic 840<sup>1</sup> are included in the lessor's net investment in the lease. Unamortized amounts are not reassessed even if the lessor does not elect the package of practical expedients. Those amounts are not reassessed because the Board decided that sales-type/direct financing lessors should carry forward the same net investment in the lease they had under Topic 840 to Topic 842 at the transition date. Reassessing unamortized initial direct costs for those leases would have rendered that impossible in most cases given the substantially different definitions of initial direct costs between Topic 840 and Topic 842.  
[842-10-65-1(x)(1)]

Note:

1. Initial direct costs are not capitalized in connection with a sales-type lease under Topic 840.



### Question 13B.4.20

#### **Revenue recognition guidance for arrangements that no longer meet the definition of a lease**

**What revenue recognition guidance does a lessor apply to contracts that no longer meet the definition of a lease on adoption of Topic 842 if it uses the cumulative-effect method to transition to Topic 606?**

**Background:** ABC Corp. adopts Topic 606 on January 1, 2018 using the cumulative-effect method (i.e. rather than the full retrospective method). ABC applies the guidance in Topic 606 to all contracts in 2018 and recognizes the cumulative effect of initial adoption of Topic 606 in the opening balance of retained earnings on January 1, 2018. The adoption of Topic 606 does not affect ABC's accounting for lease arrangements in the scope of Topic 840.

ABC adopts Topic 842 on January 1, 2019 and does not elect the package of practical expedients. On adoption of Topic 842, ABC concludes that an arrangement previously accounted for as a lease under Topic 840 does not meet the definition of a lease under Topic 842. Instead, ABC concludes the arrangement provides a service in the scope of Topic 606. This arrangement commenced in 2017.

**Interpretive response:** On adoption of Topic 842, ABC should apply the guidance in Topic 606 to the arrangement that is no longer a lease, beginning with the 2018 comparative period. ABC should also recognize the cumulative effect of initially applying Topic 606 to that arrangement in the January 1, 2018 opening retained earnings balance.

ABC should apply the guidance in Topic 605 to the arrangement for the 2017 comparative period, with the effect of applying Topic 605 for the first time recognized as part of the Topic 842 transition adjustment on January 1, 2017 (the date of initial application of Topic 842).

ABC does not apply the guidance in Topic 606 when restating the 2017 comparative period in its 2019 financial statements because ABC did not adopt Topic 606 until 2018 and elected the cumulative-effect transition method for the adoption of that standard.

### **13B.4.3 ASU 2018-20, Narrow-Scope Improvements for Lessors**

13B.4.190 ASU 2018-20 (issued December 10, 2018) enacted the following amendments to Topic 842:

- created a lessor-only practical expedient for sales and other similar taxes (see paragraphs 7.3.210 – 7.3.240);
- created differential accounting for lessor costs and lessee payments thereof based on which party (lessee or lessor) remits payment for the

cost to the relevant third party – e.g. the taxing authority or insurer. Paragraphs 7.3.160 – 7.3.200 discuss these requirements; and

- clarified that a lessor should recognize variable payments not included in the consideration in the contract as follows (see section 4.4.3):
  - the portion allocated to the separate lease component in the period in which the changes in facts and circumstances on which the payment is based occur; and
  - the portion allocated to the non-lease component(s) as revenue when the requirements of the applicable Topic (e.g. Topic 606) are met.

### ***Entities that did not adopt Topic 842 before issuance of ASU 2018-20***

13B.4.200 Lessors that did not early adopt Topic 842 before ASU 2018-20 was issued will adopt the amendments in paragraph 13B.4.190 when they adopt Topic 842. The amendments will apply to all new and existing leases from the date of initial application – e.g. January 1, 2017 for a calendar year-end public business entity. [842-10-65-3(a)]

### ***Entities that early adopted Topic 842 before issuance of ASU 2018-20***

13B.4.210 Lessors that early adopted Topic 842 will adopt the amendments in ASU 2018-20 as of their mandatory Topic 842 adoption date – e.g. January 1, 2019 for a calendar year-end public business entity. [842-10-65-3(b)]

13B.4.220 Alternatively, lessors can elect to apply the amendments to all new and existing leases in either: [842-10-65-3(b)]

- the first reporting period ending after the issuance of ASU 2018-20 – e.g. the quarter beginning October 1, 2018 for a calendar year-end public business entity; or
- the first reporting period beginning after the issuance of ASU 2018-20 – e.g. the quarter beginning January 1, 2019 for a calendar year-end public business entity.

13B.4.230 Lessors will apply the amendments either: [842-10-65-3(c)]

- retrospectively to all prior annual and interim periods *after* the entity's Topic 842 date of initial application; or
- prospectively from the entity's adoption date of the amendments.

## **13B.4.4 ASU 2019-01, Codification Improvements**

13B.4.240 ASU 2019-01 (issued March 5, 2019) enacted the following amendments to Topic 842.

- reinstated guidance from Topic 840 requiring lessors that are not manufacturers or dealers to measure the fair value of the underlying asset at its cost after reflecting any volume or trade discounts applied; cost

includes acquisition costs such as sales taxes and delivery and installation costs. An exception arises if there is a significant time lapse between asset acquisition and lease commencement. In those cases, the lessor determines the fair value of the underlying asset in accordance with Topic 820 (fair value measurements). Section 7.3.1 further discusses this guidance; and [842-30-55-17A]

- requires lessors that are depository or lending institutions in the scope of Topic 942 (financial services—depository and lending) to classify the principal portion of lease payments received under sales-type or direct financing leases as cash flows from investing activities. The interest portion of those lease payments and all lease payments received under operating leases are classified as cash flows from operating activities. [842-30-45-5, 942-230-45-4]

13B.4.250 The effective dates of the amendments in ASU 2019-01 are as follows. [842-10-65-4(a)]

Effective date	Public business entities	All other entities
Annual periods – fiscal years beginning after	December 15, 2019	December 15, 2021
Interim periods – in fiscal years beginning after	December 15, 2019	December 15, 2022
Early adoption allowed?	Yes	Yes

13B.4.260 On adoption, a lessor applies these amendments retrospectively from its date of initial application of Topic 842. For example, a calendar year-end public business entity lessor that adopts the amendments on January 1, 2020 retrospectively applies the amendments from its Topic 842 date of initial application of January 1, 2017. [842-10-65-4(b)]

## 13B.4.5 ASU 2021-05, Lessors—Certain Leases with Variable Lease Payments

13B.4.270 ASU 2021-05 (issued July 19, 2021) requires a lessor to classify a lease with variable lease payments that do not depend on an index or rate as an operating lease if: [842-10-25-3A]

- the lease would have been classified as a sales-type lease or a direct financing lease under the pre-ASU classification criteria; and
- sales-type or direct financing classification would result in a commencement date loss.

13B.4.280 The effective dates of the amendments in ASU 2021-05 are as follows. [842-10-65-5]

Effective date	Public business entities	Other entities
Annual periods – fiscal years beginning after	December 15, 2021	December 15, 2021

Effective date	Public business entities	Other entities
Interim periods – in fiscal years beginning after	December 15, 2021	December 15, 2022
Early adoption allowed?	Yes, but not before adopting ASC 842.	

13B.4.290 The available transition approaches depend on the entity's Topic 842 adoption status as of July 19, 2021 (i.e. the issuance date of ASU 2021-05).

- **Lessors that have not yet adopted Topic 842** will adopt the amendments in ASU 2021-05 at the same time and using the same transition method they use to adopt Topic 842 – either the effective date method or the comparative method (see chapters 13A and 13B, respectively).
- **Lessors that have already adopted Topic 842** will apply the amendments in ASU 2021-05 either:
  - retrospectively to leases that commenced or were modified on or after the entity's adoption of Topic 842 (e.g. on January 1, 2019 for a calendar-year public business entity); or
  - prospectively to leases that commence or are modified (and that modification is not accounted for as a separate contract) after the entity adopts the ASU 2021-05 amendments.

## 13B.4.6 ASU 2023-01, Common Control Arrangements

13B.4.320 ASU 2023-01 (issued March 27, 2023) contains amendments to Topic 842 around two issues that apply to arrangements between entities under common control. One the amendments related to the first of those two issues (**Issue 1**) applies to lessors.

Effective date	All entities
Annual periods – fiscal years beginning after	December 15, 2023
Interim periods – in fiscal years beginning after	December 15, 2023
Early adoption allowed?	Yes, in any annual or interim period, as of the beginning of the fiscal year, for which financial statements have not yet been made available for issuance
Entities that have not issued (or made available for issuance) financial statements under Topic 842 before final ASU was issued	May adopt concurrent with Topic 842

13B.4.330 The Issue 1 amendments permit a private entity (lessee or lessor) to elect a practical expedient to use the written terms and conditions, as opposed to the legally enforceable terms and conditions, of a common control leasing

arrangement to determine whether a lease exists and, if so, to determine the classification of and accounting for that lease. See section 3.1.2. [842-10-15-3A]

13B.4.340 The available transition approaches depend on the entity's Topic 842 adoption status as of March 27, 2023 (i.e. the issuance date of ASU 2023-01). [842-10-65-7]

- **Private entities that have not yet issued (or made available for issuance) financial statements under Topic 842** have the option to adopt the amendments in their first Topic 842 compliant financial statements and use the same transition method as they used to adopt the remainder of Topic 842 (i.e. the comparative method – for the effective date method, see chapter 13A).
- **Private entities that have already applied Topic 842 in financial statements that have been issued (or made available for issuance)** have the option to adopt the amendments:
  - prospectively to common control arrangements that commence or are modified on or after the entity's adoption date of the ASU (e.g. January 1, 2024 if a calendar year end entity that does not early adopt the amendments); or
  - on a modified retrospective basis to all leases that exist at the entity's adoption date of the ASU.

Under the modified retrospective transition approach, the entity records the effect of adopting the amendments through a cumulative-effect adjustment to retained earnings at the beginning of the earliest period presented in the financial statements.

For example, assume that a calendar year private entity adopted Topic 842 on January 1, 2022; adopted the Issue 1 amendments on January 1, 2024; and is issuing financial statements that will present 2023 and 2024. Under this transition approach, the entity would record the required cumulative-effect adjustment as of January 1, 2023 (beginning of earliest period presented), but based on an assumed retrospective application as of January 1, 2022 (Topic 842 adoption date) to common control arrangements still in place at January 1, 2024.

## 13B.5 Applying the guidance on components of a contract in transition

13B.5.10 Neither the transition guidance in Topic 842, nor the ASU 2016-02 basis for conclusions, explicitly discuss the effect of the new guidance on identifying, separating and allocating the 'consideration in the contract' to components of a contract (see chapter 4) on transition.

13B.5.20 However, we believe the requirements with respect to the new components guidance in transition can be derived from other requirements in the transition guidance. Sections 13B.5.1 and 13B.5.2 describe what we believe the effect (or non-effect) of this guidance is on the various transition scenarios presented, assuming the entity previously appropriately applied the guidance in Topic 840 with respect to (1) identifying lease and non-lease elements and (2)

separating elements and allocating contract consideration. As discussed in Question 13B.2.100, the transition guidance in Topic 842 does not grandfather prior errors in applying Topic 840.

13B.5.30 Each of these scenarios assumes that the lease is *not* modified (lessees and lessors) or remeasured (lessees only) on or after the effective date. If a lease is modified (and that modification is not accounted for as a separate contract) or remeasured on or after the effective date, all of the requirements of Topic 842 become applicable to that lease, including the guidance on accounting for components of a contract.

## 13B.5.1 Lessee guidance

### ***Operating → Operating***

13B.5.40 Lessees will not reevaluate their previous allocations to lease and non-lease elements of a contract. This is because, absent a post-effective date modification or remeasurement, the transition guidance requires lessees to use the 'minimum rental payments' determined in accordance with Topic 840 to account for the lease (see Question 13B.3.10). Revising previous decisions with respect to identification, separation and/or allocation of contract consideration would change the amounts used to account for the lease, directly contradicting the explicit requirement to account for the lease based on the minimum rental payments as determined under Topic 840.

### ***Operating → Finance***

13B.5.50 The transition guidance applicable to this scenario requires the lessee to recognize and measure a new finance lease liability in the same way as for an operating lease that remains classified as an operating lease, and to derive the new finance lease ROU asset from the finance lease liability at the commencement date (see section 13B.3.2).

13B.5.60 Measurement of the lease liability is based on the minimum rental payments (as defined in Topic 840). Revising previous decisions with respect to identification, separation and/or allocation of contract consideration would change the amounts used to account for the lease, contradicting the explicit requirement to account for the lease based on the minimum rental payments as determined under Topic 840.

### ***Finance → Finance***

13B.5.70 Lessees will not reevaluate their previous allocations to lease and non-lease elements of a contract. This is because the transition guidance requires lessees to measure the initial finance lease ROU asset and initial finance lease liability at the same amounts recognized immediately before the transition date for the capital lease asset and the capital lease obligation, respectively (except as noted in Question 13B.2.50).

13B.5.80 In addition, absent a post-effective date modification or remeasurement, lessees will not remeasure those amounts; they will simply complete the accounting for the lease based on those initially measured

amounts. Similar to the operating lease to operating lease scenario in paragraph 13B.5.40, revisions to decisions made about components of the contract would require the lessee not to follow the explicit measurement requirements for this scenario.

### ***Finance → Operating***

13B.5.90 The transition guidance applicable to this scenario requires the lessee to derecognize its existing capital lease asset and capital lease obligation and, at the transition date, recognize and measure a new operating lease liability in accordance with Topic 842 and derive the new operating lease ROU asset from that lease liability.

13B.5.100 Measurement of the lease liability in accordance with Topic 842 is based on the lease payments. Because the lease payments are a function of the separation and allocation guidance in Topic 842 if there are either (1) multiple separate lease components or (2) lease and non-lease components of the contract, lessees will need to apply the Topic 842 multiple-component separation and allocation guidance (see section 4.4) to comply with the transition measurement requirements.



**Question 13B.5.10**  
**Not separating lease from non-lease components  
for existing leases on transition**

### **Is the practical expedient for a lessee to not separate lease and non-lease components a policy election available to lessees for existing leases?**

**Background:** As a practical expedient, a lessee may elect not to separate non-lease components from the lease components to which they relate. A lessee applies this practical expedient as an accounting policy election by class of underlying asset – e.g. office equipment, automobiles, office space. However, there is no mention in Topic 842 as to whether a lessee could similarly apply this expedient to existing leases on transition. [842-10-15-37]

**Interpretive response:** Yes. While not explicitly provided for in the transition guidance, we believe lessees are permitted to make an accounting policy election (by class of underlying asset) to not separate non-lease elements (e.g. substantial services such as those to operate the asset) from the lease elements to which they relate for existing leases.

For example, a lessor's operation of the underlying asset (e.g. services to operate a ship or an airplane) is an example of a substantial service that is accounted for separate from the lease element. Therefore, in an operating lease, a lessee electing the non-separation practical expedient for existing leases on transition will account for fixed costs allocable to the operation services as part of the minimum rental payments that are used to measure the operating lease liability.

The Board decided to permit the non-separation practical expedient for leases that commence on or after the effective date to ease the accounting for lessees, and many of the transition provisions were similarly intended. Therefore, we believe it is acceptable for lessees to apply the expedient to existing leases on transition.



### Question 13B.5.20

#### **Accounting policy implications of separating lease from non-lease components for existing leases on transition**

**If a lessee does not elect the lease/non-lease component practical expedient on transition, is this a binding accounting policy election going forward for new leases that commence after the effective date?**

**Interpretive response:** No. We do not believe there is a basis in Topic 842 for prohibiting a lessee from electing the practical expedient for new leases that commence on or after the effective date solely because it did not elect to apply the practical expedient on transition, application of which is not addressed in Topic 842 or ASU 2016-02 (see Question 13B.5.10).

However, based on related discussions with the SEC staff, we believe a lessee should only apply the lease/non-lease practical expedient to existing leases on transition if it will do so for new leases of underlying assets within the same class commencing on or after the effective date of Topic 842.

## **13B.5.2 Lessor guidance – practical expedient for separation of lease and non-lease components does not apply**

### ***Operating → Operating***

13B.5.110 The transition guidance requires lessors in this scenario to continue to recognize the underlying asset, as well as any other lease assets and liabilities (e.g. accrued rent assets or deferred rent liabilities), at the same amounts as immediately before the transition date under Topic 840. If a contract that contains an operating lease includes multiple lease components and/or lease and non-lease components, revising the units of account and revising the allocation of the consideration in the contract (which might be different from the total contract consideration under Topic 840 if there are variable payments that specifically relate to non-lease components of the contract) would likely result in adjustments to any recognized lease assets or liabilities – i.e. a change would have resulted in a change to the lease payments, and therefore the accrued/deferred rent amount would typically be measured differently from that which resulted under Topic 840.

### **Sales-type/direct financing → Sales-type/direct financing**

13B.5.120 Lessors will not reevaluate their previous allocations to lease and non-lease elements of a contract. This is because the transition guidance requires lessors to measure their initial lease assets under Topic 842 at the same amount recognized immediately before the transition date under Topic 840.

13B.5.130 In addition, absent a post-effective date modification not accounted for as a separate contract, lessors in this scenario will not remeasure their lease assets, they will simply complete the accounting for the lease based on the initially measured amount for the net investment in the lease.

### **Operating → Sales-type/direct financing; or Sales-type/direct financing → Operating**

13B.5.140 The transition guidance states for either of these scenarios that "the objective is to account for the lease, beginning on the later of the beginning of the earliest comparative period presented in the financial statements and the commencement date of the lease, as if it had always been accounted for as an operating [a sales-type or direct financing] lease in accordance with this Topic." It therefore seems clear that this would include reassessing the lessor's accounting with respect to the components of the contract.



Question 13B.5.30

### **Topic 842 and Topic 606 interaction in accounting for CAM**

#### **How should a lessor account for CAM provided in a lease after it adopts Topic 606 but before it adopts Topic 842?**

**Background:** Topic 840 specifies that CAM is within its scope based on the following. [840-10-25-1(d), 15-17, 15-19(a)]

- It describes maintenance as an executory cost.
- It states that "if an arrangement contains a lease and related *executory costs*, as well as other non-lease elements, the classification, recognition, measurement, and disclosure requirements of this Topic shall be applied by both the purchaser and the supplier to the lease element of the arrangement." [emphasis added]
- It characterizes related executory costs as part of 'those for the lease'.

#### **Interpretive response:**

##### **Accounting for existing leases before the effective date of Topic 842**

Topic 606 is a 'residual standard' in that it requires the application of other Topics *first* if those other Topics specify how to account for one or more parts of the contract. Topic 606 only applies to those parts of the contract that other Topics do not address.

CAM expenditures are described as 'executory costs', and accounted for as part of the lease element under Topic 840. Therefore, CAM is not governed by

Topic 606 for leases that commence before the effective date of Topic 842, and an entity may continue to account for CAM under its historical accounting policy. That said, on the adoption of Topic 606, based on discussions with the FASB and SEC staffs, we believe it would be acceptable for an entity to either (or both): [606-10-15-4]

- analogize to the guidance in Topic 606 in determining the measure of progress to apply when recognizing CAM revenue – i.e. rather than follow its historical accounting policy for recognizing CAM; and/or
- separately present CAM revenues as non-lease revenue. If a lessor decides to separately present CAM revenue as non-lease revenue, it is acceptable to allocate revenue between the lease and CAM using either: (1) the requirements in Topic 840 or (2) the transaction price allocation guidance in Topic 606 (see paragraphs 13B.5.150 – 13B.5.160). On adoption of Topic 842, that separate presentation (if elected) should be reflected in the comparative periods presented.

#### **Accounting for existing leases after the effective date of Topic 842**

Assuming that lease classification is the same before and after adoption of Topic 842 (unless the lease is modified on or after the effective date and that modification is not accounted for as a separate contract), the lessor will not reevaluate the identification of and allocation to lease and non-lease components (see paragraphs 13B.5.110 – 13B.5.130). The lessor will continue to account for CAM provided as part of the lease contract just as it did before the effective date of Topic 842 (see above).

#### **Accounting for leases that commence or are modified on or after the effective date of Topic 842**

For all leases that commence or are modified on or after the effective date of Topic 842 (and for which that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8), the lessor will identify CAM as a non-lease component and account for it under Topic 606.



#### Observation

##### **Lessor reallocation may be permissible in some cases**

13B.5.150 The discussion in paragraphs 13B.5.110 – 13B.5.130 notwithstanding, the SEC staff has communicated that they may not object to a lessor beginning to account for maintenance services (including common area maintenance), which is a lease-related element under Topic 840, as a non-lease element beginning with the lessor's adoption of Topic 606 if the lessor adopts Topic 606 before it adopts Topic 842. Under this approach, we believe the lessor would account for those services as within the scope of Topic 606 and would allocate the contract consideration between the remaining lease elements and any non-lease elements (including maintenance services) in accordance with the transaction price allocation guidance in paragraphs 606-10-32-28 – 32-41.

13B.5.160 The lessor's accounting in this regard would follow the lessor's Topic 606 transition approach (full retrospective approach or cumulative effect approach).

13B.5.170 Taken as a whole, we believe entities will only be required to reassess their identification and accounting for components of a contract when the lease classification changes as a result of applying Topic 842 to the lease. If lease classification does not change or the entity elects the package of practical expedients, which means the entity will not reassess classification of its leases under Topic 842, entities will not be required to reassess their identification of or accounting for multiple components of a contract. Avoiding the effort to reassess the accounting for components of a contract and avoiding the operational complexities that could arise from that exercise if classification of a lease does change is another reason many entities will likely consider electing the package of practical expedients.

13B.5.180 However, consistent with the discussion in Question 13B.2.100 about identifying leases, the ability to not reassess identification of or accounting for multiple components of a contract presumes the entity applied the guidance in Topic 840 completely and accurately. For example, if an entity did not appropriately identify lease and non-lease elements, or did not appropriately separate 'minimum rental payments' or 'minimum lease payments' from payments for non-lease elements (e.g. services), the transition guidance does not excuse those errors.



### Question 13B.5.40

#### **Existing arrangements with lease and non-lease elements – substantial services**

#### **What guidance applies to a lessor when accounting for 'substantial services' provided to a lessee on transition?**

**Background:** Topic 840 required a lessor to separate, at lease inception, payments and other consideration into those: [840-10-15-19]

- related to the lease, including the related executory costs; and
- for other services.

Under Topic 840, the term 'executory costs' referred to the normal expenses associated with owning an asset, including insurance, maintenance and taxes. Therefore, activities identified as giving rise to executory costs, such as most maintenance services, were not non-lease elements. 'Substantial services' were accounted for separately from the lease (under Topic 605 before the adoption of Topic 606). [840-10-25-1(d), 840-10-15-8 – 15-19]

Before the adoption of Topic 606, the components were required to be separated on a relative selling price basis. After the adoption of Topic 606, lessors separate lease from non-lease components (which includes substantial service elements) using the transaction price allocation guidance in Topic 606. [840-10-15-19]

**Interpretive response:** Substantial services were non-lease elements under Topic 840. Therefore, before the lessor's adoption of Topic 606 they were required to be accounted for under Topic 605 (or other relevant pre-Topic 606 revenue guidance). Consequently, substantial services become subject to Topic 606 for lessors on transition to Topic 606, and should be transitioned using the same guidance that applies to all other elements that were subject to the pre-Topic 606 revenue guidance. The consideration in the lease contract, however, is not reallocated between the lease and non-lease elements on adoption of Topic 606 and the lessor continues to use the consideration allocated to the non-lease component based on the Topic 840 allocation guidance (see also Question 13B.5.30).

If substantial service elements were accounted for as being in the scope of Topic 840 (i.e. as part of a lease element), this is a non-GAAP accounting policy that is subject to financial statement materiality considerations. There is no practical expedient in transition to Topic 606 that would permit a substantial service element to be accounted for as part of a lease after the adoption of Topic 606.

#### **Lessor practical expedient not to separate lease and non-lease components**

As discussed in section 13B.5.3, a lessor that elects the non-separation practical expedient for lease and non-lease components will combine lease and substantial service elements in existing leases that meet the specified criteria (see paragraph 13B.5.190) beginning:

- For non-early adopters, on the date of initial application; and
- For early adopters:
  - either (1) in the first reporting period following the issuance of ASU 2018-11 (e.g. the beginning of the fiscal quarter following the issuance date of the ASU) or (2) at the entity's mandatory Topic 842 adoption date (e.g. January 1, 2019 for a calendar year-end public business entity); and
  - retrospectively to all reporting periods after the date of initial application.

For example, a lessor is not early adopting Topic 842 and will combine its ship lease and operations service elements for new leases under Topic 842. In that case, the lessor will also present ship lease and operations service (i.e. substantial service) revenue for *existing* leases on a combined basis beginning on the date of initial application of Topic 842; this includes combining the lease and substantial operation service elements for presentation purposes in the comparative periods.

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### **13B.5.3 Lessor guidance – practical expedient for separation of lease and non-lease components applies**

13B.5.190 Topic 842 provides a lessor practical expedient whereby the lessor can make an accounting policy election, by class of underlying asset, not to separate lease and related non-lease components if both: [842-10-15-42A]

- the timing and pattern of transfer to the lessee of the lease component and the non-lease component(s) associated with that lease component are the same; and
- the lease component, if accounted for separately, would be classified as an operating lease.

Paragraphs 4.4.51 – 4.4.56 discuss the lessor practical expedient in detail.

### ***Entities that have not adopted Topic 842 on issuance of ASU 2018-11***

13B.5.200 Lessors that had not early adopted Topic 842 when ASU 2018-11 was issued may elect the practical expedient when they adopt Topic 842.

13B.5.210 For existing leases (i.e. those that commence before the effective date), lessors will apply the non-separation practical expedient from the date of initial application. That is, a lessor will combine lease and non-lease components arising from an existing lease if they would also do so if the lease were a new lease that commenced on or after the entity's adoption date. [842-10-65-2(a)]

### ***Entities that early adopted Topic 842 before the issuance of ASU 2018-11***

13B.5.220 Lessors can elect the practical expedient at either:

- the beginning of the entity's first reporting period following the issuance of ASU 2018-11 – e.g. the beginning of the fiscal quarter following the issuance date of the ASU; or
- at the entity's mandatory Topic 842 adoption date – e.g. January 1, 2019 for a calendar year-end public business entity.

13B.5.230 For existing leases (i.e. those that commence before the lessor's adoption of the practical expedient), lessors will apply the non-separation practical expedient retrospectively to all prior annual and interim periods after the date of initial application.

## 13B.6 Leveraged leases



### **Excerpt from ASC 842-10**

#### **65 Transition and Open Effective Date Information**

##### **General**

> Transition Related to Accounting Standards Updates No. 2016-02, Leases (Topic 842), No. 2018-01, Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842, No. 2018-10, Codification Improvements to Topic 842, Leases, No. 2018-11, Leases (Topic 842): Targeted Improvements, No. 2018-20, Leases (Topic 842): Narrow-Scope Improvements for Lessors, 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, No. 2020-05, Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities, No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*, No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*, and No. 2023-01, *Leases (Topic 842): Common Control Arrangements*

**65-1** The following represents the transition and effective date information related to Accounting Standards Updates No. 2016-02, *Leases (Topic 842)*, No. 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*, No. 2018-10, *Codification Improvements to Topic 842, Leases*, No. 2018-11, *Leases (Topic 842): Targeted Improvements*, No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, 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*, No. 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*, No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*, No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*, and No. 2023-01, *Leases (Topic 842): Common Control Arrangements*: [Note: See paragraph 842-10-S65-1 for an SEC Staff Announcement on transition related to Update 2016-02.]

#### **Leases previously classified as leveraged leases under Topic 840**

- z. For leases that were classified as **leveraged leases** in accordance with Topic 840, and for which the commencement date is before the effective date, a lessor shall apply the requirements in Subtopic 842-50. If a leveraged lease is modified on or after the effective date, it shall be accounted for as a new lease as of the effective date of the modification in accordance with the guidance in Subtopics 842-10 and 842-30.
  - 1. A lessor shall apply the pending content that links to this paragraph to a leveraged lease that meets the criteria in (z) that is acquired in a business combination or an **acquisition by a not-for-profit entity** on or after the effective date.

13B.6.10 For leases classified as leveraged leases under Topic 840 and for which the commencement date is before the effective date, a lessor continues its existing leveraged lease accounting, even if the lessor does not elect the package of transition practical expedients (see paragraph 13B.2.100). However, if a leveraged lease is modified on or after the effective date, it is accounted for as a new lease at the modification date in accordance with Topic 842. [842-10-65-1(z)]

13B.6.20 If a lessee exercises an option to extend a leveraged lease that commenced before the effective date of Topic 842 for which exercise was not previously considered reasonably assured, the exercise of that option is considered a lease modification. [842-50-15-1]

13B.6.30 For further discussion of leveraged leases, see section 7.8.



## Question 13B.6.10 Acquired leveraged leases

### If a leveraged lease is acquired, does the lessor continue to apply leveraged lease accounting?

**Background:** The lease could be acquired separately, or as part of a business combination (or an acquisition by a not-for-profit entity).

**Interpretive response:** Yes, provided that the lease is not modified as part of the acquisition. The lessor will continue to apply the leveraged lease guidance in Subtopic 842-50 (leveraged lease arrangements) (see section 7.8).

## 13B.7 Sale-leaseback transactions



### Excerpt from ASC 842-10

#### 65 Transition and Open Effective Date Information

##### General

> Transition Related to Accounting Standards Updates No. 2016-02, Leases (Topic 842), No. 2018-01, Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842, No. 2018-10, Codification Improvements to Topic 842, Leases, No. 2018-11, Leases (Topic 842): Targeted Improvements, No. 2018-20, Leases (Topic 842): Narrow-Scope Improvements for Lessors, 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, No. 2020-05, Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities, No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*, No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*, and No. 2023-01, *Leases (Topic 842): Common Control Arrangements*

**65-1** The following represents the transition and effective date information related to Accounting Standards Updates No. 2016-02, *Leases (Topic 842)*, No. 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*, No. 2018-10, *Codification Improvements to Topic 842, Leases*, No. 2018-11, *Leases (Topic 842): Targeted Improvements*, No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, 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*, No. 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*, No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*, No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*, and No. 2023-01, *Leases (Topic*

*842): Common Control Arrangements: [Note: See paragraph 842-10-S65-1 for an SEC Staff Announcement on transition related to Update 2016-02.]*

### **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.
- ee. If a previous sale and leaseback transaction was accounted for as a sale and operating leaseback in accordance with Topic 840, the transferor shall do the following:

1. Recognize any deferred gain or loss not resulting from off-market terms (that is, where the consideration for the sale of the asset is not at **fair value** or the lease payments are not at market rates) as a cumulative-effect adjustment 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)).

13B.7.10 If a sale-leaseback transaction was previously accounted for as a sale and a leaseback under Topic 840, an entity does not reassess whether the transaction would have qualified as a sale (or purchase) under Topic 842. This means that buyer-lessors will not revisit whether a purchase of the underlying asset occurred for any sale-leaseback transactions for which the sale/purchase occurred before the effective date. [842-10-65-1(aa)]

13B.7.20 An entity accounts for the leaseback in accordance with the lessee and lessor transition requirements outlined in sections 13B.2 – 13B.5. [842-10-65-1(cc)]

13B.7.30 If a transaction was previously accounted for as a sale and capital (finance) leaseback under Topic 840, a seller-lessee continues to amortize any deferred gain or loss existing at the later of the beginning of the earliest period presented or the date of sale of the underlying asset as follows. [842-10-65-1(dd)]

- If the asset is land only, over the remaining lease term on a straight-line basis.
- If the asset is not land only:
  - in proportion to the amortization of the ROU asset if the leaseback is a finance lease; and
  - in proportion to total lease cost recognized in profit or loss if the leaseback is an operating lease.

13B.7.40 If a transaction was previously accounted for as a sale and operating leaseback under Topic 840, a seller-lessee (see Example 13B.7.20):  
[842-10-65-1(ee)]

- recognizes the portion of any deferred gain or loss not resulting from off-market terms at the later of the beginning of the earliest period presented (as a cumulative-effect adjustment to equity) or the date of sale (in earnings of the comparative period presented); and
- recognizes the portion of any deferred gain or loss that resulted from off-market terms as an adjustment to the leaseback ROU asset (if the sales price was below market) or as a remaining financial liability (if the sales price was above market) at the transition date.

13B.7.50 Consistent with the transition requirements for lessees and lessors, the sale-leaseback transition requirements generally limit the implementation cost and complexity for preparers. A seller-lessee will recognize an adjustment to equity in transition only for sale and operating leasebacks for which there is a deferred gain or loss not resulting from off-market terms.

13B.7.60 If a previous sale-leaseback transaction was, and continues to be at the effective date, accounted for as a failed sale under Topic 840, the entity reassesses whether a sale would have occurred at any point on or after the beginning of the earliest period presented in the financial statements in accordance with Topic 842. If so, the sale-leaseback transaction is accounted for on a modified retrospective basis – i.e. in accordance with the transition guidance applicable to sale and operating leasebacks – from the date a sale is determined to have occurred. [842-10-65-1(bb)]



### Question 13B.7.10

#### **Leaseback accounting on transition for previously failed sales**

**What is the seller-lessee's accounting for a sale-leaseback transaction that remains a failed sale under Topic 840 at the effective date?**

**Interpretive response:**

**Accounting for the sale**

If the sale criteria in Subtopic 842-40 (see section 9.1) are met as of the beginning of the earliest period presented (because as of that point in time there are no conditions precluding a sale under Subtopic 842-40), we believe the gain or loss on the sale of the underlying asset should be recognized as an adjustment to equity as of that date. [842-10-65-1(bb)(1)]

In contrast, if the sale criteria in Subtopic 842-40 are met during the transition period, we believe the gain or loss on the sale of the underlying asset should be recognized in the period the sale criteria are met.

The guidance in section 9.2 applies if the sale criteria in Subtopic 842-40 are met after the effective date of Topic 842.

**Accounting for the leaseback**

If the sale criteria in Subtopic 842-40 are met before the effective date of Topic 842, the accounting for the leaseback should follow the transition

provisions discussed in sections 13B.2 and 13B.3 as if the lease commencement date were the later of the date of initial application or the date that a sale is determined to occur under Subtopic 842-40.

If the entity has elected the package of transition practical expedients (see section 13B.2.3), we believe the preceding paragraph means the following.

- Because this was previously determined to be a failed sale-leaseback transaction, there would be no additional consideration as to whether the leaseback meets the definition of a lease under Topic 842.
- Because there was no lease accounted for under Topic 840 (i.e. because the transaction was accounted for as a failed sale-leaseback) the lessee had not classified the lease under Topic 840. In the absence of specific guidance in Topic 842, we believe it is acceptable for the lessee to assess classification of the lease as of either:
  - the lease commencement date, using the lease classification guidance in Topic 842; or
  - The lease inception date, using the lease classification guidance in Topic 840.

We believe the first approach is acceptable, even though the package of practical expedients has been elected, because there was no 'existing lease' that had been previously classified under Topic 840. However, we believe that to apply this approach, the entity must determine the commencement date of the leaseback (i.e. when a sale would have successfully occurred) under Topic 842.

Alternatively, we believe the second approach is acceptable because election of the package of transition practical expedients effectively grandfathered the legacy Topic 840 classification guidance, which required lease classification to be assessed at lease inception.

We believe an entity's chosen approach should be applied consistently to all similar circumstances.

- Any unamortized initial direct costs capitalized because the transaction was accounted for as a failed sale will not be reassessed, despite the fact that those costs may have been expensed as transaction costs of the sale had the transaction been a successful sale and leaseback under Topic 840. Those costs will be accounted for by the lessee in the same manner as any other unamortized initial direct costs are accounted for by lessees that elect the package of transition practical expedients.



### Question 13B.7.20

#### **Successful sale-leaseback transactions that include seller-lessee repurchase options on adoption of Topic 606**

**Is a transaction accounted for as a sale and a leaseback under Topic 840 that includes a seller-lessee repurchase option reassessed as a financing arrangement because of the repurchase agreements guidance in Topic 606?**

**Background:** This question arises because Topic 606 states that if an entity has an obligation (a forward) or a right (a call option) to repurchase an asset, then the customer does not obtain control of the asset – i.e. no sale occurs for revenue recognition purposes. An entity accounts for the contract as a lease or a financing arrangement depending on the relationship between the repurchase amount and the original selling price. Further, if the contract is part of a sale-leaseback transaction, the entity should account for the contract as a financing arrangement. [606-10-55-68, ASU 2014-09.BC426]

In contrast, the transition guidance in Topic 842 states that if a previous sale-leaseback transaction was accounted for as a sale and a leaseback in accordance with Topic 840, an entity does not reassess the transaction to determine whether the transfer of the asset would have been a sale. In addition, the sale-leaseback guidance in Subtopic 840-40 was not amended by ASU 2014-09 (or any of the subsequent revenue ASUs) such that all sale-leaseback transactions remain within its scope until Topic 842 is adopted and no guidance to refer to Topic 606 in the case of a seller-lessee repurchase option was added. [842-10-65-1(aa), 840-40-05-1]

**Interpretive response:** No. We believe a successful sale-leaseback transaction under Topic 840 should not be reassessed on transition to Topic 842. This is because of the combination of the transition guidance in Topic 842 (clearly delineating the Board's intent with respect to successful sale-leaseback transactions) plus the fact that Subtopic 840-40 was not amended by any of the revenue ASUs. We believe this to be the case even if the transaction includes a seller-lessee repurchase option. [842-10-65-1(aa), 840-40-05-1]

We believe this conclusion is further supported for sale-leaseback transactions with noncustomers by the fact that Subtopic 610-20 on the derecognition of nonfinancial assets (as amended by ASU 2017-05) specifically excludes from its scope any sale-leaseback transactions that were in the scope of Subtopic 840-40. [610-20-15-4(c)]



### Example 13B.7.10

#### **Sale-leaseback transaction previously accounted for as a sale and an operating leaseback under Topic 840**

The following summarizes relevant information about Seller-Lessee SL's equipment sale-leaseback transaction with Buyer-Lessor BL. The transaction qualified as a sale and a leaseback – i.e. there was no failed sale.

Sale-leaseback transaction date:	January 1, 2018
Beginning of earliest period presented:	January 1, 2017
Leaseback term:	5 years
Leaseback payments (annual, paid in arrears):	\$15,000
Sales price and fair value of equipment at transaction date:	\$115,000
Carrying amount of equipment at transaction date:	\$80,000
Remaining economic life of the equipment at transaction date:	9 years
Leaseback classification:	Operating lease
Initial direct costs:	None
Lessee residual value guarantee:	None

There is no automatic reversion of ownership to SL, nor does SL have an option to repurchase the equipment. SL retains more than a minor portion, but less than substantially all, of the remaining use of the equipment. Therefore, because the profit on the sale does not exceed the present value of the minimum lease payments under Topic 840, the entire gain of \$35,000 is deferred and will be recognized over the five-year leaseback term.

#### **Effective date and transition**

SL and BL are calendar year-end public business entities that adopt Topic 842 on January 1, 2019.

SL and BL do not reassess whether the transaction would have qualified for sale/purchase accounting under Topic 842. BL does not adjust its previous accounting for the purchase of the asset in any manner. On adoption of Topic 842, SL will record the following journal entries to (1) recognize the full amount of the profit on the sale-leaseback transaction as of the sale date (January 1, 2018), which is later than the beginning of the earliest period presented, and (2) reverse the journal entry recorded under Topic 840 to recognize one-fifth of the deferred gain during calendar 2018 (the first year of the leaseback term).

	<i>Debit</i>	<i>Credit</i>
Deferred profit on sale-leaseback transaction	35,000	
Gain on sale-leaseback transaction		35,000
<i>Recognize gain on transaction at January 1, 2018</i>		

	<i>Debit</i>	<i>Credit</i>
Gain on sale-leaseback transaction	7,000	
Deferred profit on sale-leaseback transaction		7,000
<i>Recognize portion of deferred gain in 2018 (\$35,000 / 5)</i>		

### Subsequent accounting for the leaseback

SL and BL account for the leaseback in the same manner as any other lease that commenced during the transition period.



#### Example 13B.7.20

#### Sale-leaseback deferred gains and losses in transition

Seller-Lessee SL entered into a sale-leaseback transaction under Topic 840 that qualified as a sale and operating leaseback. The following scenarios illustrate SL's treatment of the deferred gain or loss in transition under the requirements described in paragraph 13B.7.40.

The sale occurred immediately before the transition date, so that any deferred gain or loss on the sale under Topic 840 has not been amortized when evaluating the transition adjustment.

Sale and operating lease back transaction		Deferred gain/loss transition adjustment	
<b>Deferred gain scenarios</b>			
Fair value	\$100	Deferred gain recognized as a financial liability in transition because the gain only arose as a result of the sale price exceeding fair value – i.e. if the sale price had not exceeded fair value, there would not have been a gain (sale price would not have exceeded carrying amount).	
Sale price	\$110		
Carrying amount	\$105		
<b>Deferred gain</b>	<b>\$ 5</b>		
<hr/>		<i>Debit</i>	<i>Credit</i>
		Deferred gain	\$5
		Financial liability	\$5
Fair value	\$100	Deferred gain written off to equity; no portion of the gain is attributable to off-market terms because the sale price = fair value.	
Sale price	\$100		
Carrying amount	\$ 95	<i>Debit</i>	<i>Credit</i>
<b>Deferred gain</b>	<b>\$ 5</b>	Deferred gain	\$5
<hr/>		Equity	\$5

<b>Sale and operating lease back transaction</b>		<b>Deferred gain/loss transition adjustment</b>		
Fair value	\$100	\$10 deferred gain is attributable to both (1) sale price exceeding carrying amount and (2) the sale price exceeding fair value – i.e. there is a \$5 effect to each.		
Sale price	\$105			
Carrying amount	\$ 95			
<b>Deferred gain</b>	<b>\$ 10</b>	Therefore, the deferred gain is written off to both equity and to a new off-market financial liability.		
			<i>Debit</i>	<i>Credit</i>
		Deferred gain	\$10	
		Equity		\$5
		Financial liability		\$5
Fair value	\$100	Deferred gain recognized as a financial liability in transition because the gain only arose as a result of the sale price exceeding fair value – i.e. if the sale price had not exceeded fair value, there would not have been a gain (sale price would not have exceeded carrying amount).		
Sale price	\$105			
Carrying amount	\$100			
<b>Deferred gain</b>	<b>\$ 5</b>			
			<i>Debit</i>	<i>Credit</i>
		Deferred gain	\$5	
		Financial liability		\$5
Fair value	\$100	Deferred gain written off to equity; no portion of the gain is attributable to off-market terms because the sale price < fair value.		
Sale price	\$ 95			
Carrying amount	\$ 90			
<b>Deferred gain</b>	<b>\$ 5</b>			
		Deferred gain	\$5	
		Equity		\$5
<b>Deferred loss scenarios</b>				
Fair value	\$100	Deferred loss recognized as an adjustment to the new leaseback ROU asset because the sale price < fair value (i.e. loss is attributable to off-market sale price).		
Sale price	\$ 95			
Carrying amount	\$100			
<b>Deferred loss</b>	<b>\$ 5</b>			
			<i>Debit</i>	<i>Credit</i>
		ROU asset	\$5	
		Deferred loss		\$5
Fair value	\$100	Deferred loss recognized as an adjustment to the new leaseback ROU asset because the sale price < fair value (i.e. loss is attributable to off-market sale price).		
Sale price	\$ 80			
Carrying amount	\$ 95			
<b>Deferred loss</b>	<b>\$ 15</b>			
			<i>Debit</i>	<i>Credit</i>
		ROU asset	\$15	
		Deferred loss		\$15

<b>Sale and operating lease back transaction</b>		<b>Deferred gain/loss transition adjustment</b>		
Fair value	\$100	Deferred loss recognized as an adjustment to the new leaseback ROU asset because the deferred loss is attributable to the sale price being less than fair value. \$5 of the total loss was recognized on the date of sale because the carrying amount > fair value.		
Sale price	\$ 80			
Carrying amount	\$105			
<b>Deferred loss</b>	<b>\$ 20</b>			
			<i>Debit</i>	<i>Credit</i>
		ROU asset	\$20	
		Deferred loss		\$20
<b>No deferred gain/loss scenario</b>				
Fair value	\$100	N/A. There is no deferred gain or loss. The \$5 difference between carrying amount and sale price was recognized at the date of sale under Topic 840 because the carrying amount of the asset > its fair value.		
Sale price	\$100			
Carrying amount	\$105			
<b>Deferred gain/loss</b>	<b>\$ 0</b>			

## 13B.8 Build-to-suit lease arrangements



### Excerpt from ASC 842-10

#### 65 Transition and Open Effective Date Information

##### General

> Transition Related to Accounting Standards Updates No. 2016-02, *Leases (Topic 842)*, No. 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*, No. 2018-10, *Codification Improvements to Topic 842, Leases*, No. 2018-11, *Leases (Topic 842): Targeted Improvements*, No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, 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*, No. 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*, No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*, No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*, and No. 2023-01, *Leases (Topic 842): Common Control Arrangements*

**65-1** The following represents the transition and effective date information related to Accounting Standards Updates No. 2016-02, *Leases (Topic 842)*, No. 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*, No. 2018-10, *Codification Improvements to Topic 842, Leases*, No. 2018-11, *Leases (Topic 842): Targeted Improvements*, No. 2018-

20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, 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*, No. 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*, No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*, No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*, and No. 2023-01, *Leases (Topic 842): Common Control Arrangements*: [Note: See paragraph 842-10-S65-1 for an SEC Staff Announcement on transition related to Update 2016-02.]

### **Build-to-suit lease arrangements**

- 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.

## 13B.8.1 Derecognition of build-to-suit assets and liabilities

13B.8.10 The transition guidance in Topic 842 requires lessees to derecognize any assets (e.g. property, plant and equipment or construction-in-progress) and liabilities recorded solely as a result of being the accounting owner of a construction project under Topic 840 unless both: [842-10-65-1(u)]

- construction of the asset is in progress at the effective date of Topic 842; and
- the lessee is the accounting owner of the underlying asset under construction based on Topic 842 (see Section 9.4).

13B.8.20 A lessee derecognizes existing build-to-suit assets and liabilities that are recorded solely as a result of being the accounting owner of the construction project under Topic 840 at the later of the: [842-10-65-1(u)]

- beginning of the earliest period presented – i.e. the date of initial application; or
- date the lessee was determined to be the accounting owner of the asset under Topic 840.

13B.8.30 Any difference between the assets and liabilities derecognized is recorded in equity on that date – subject to the discussion in Question 13B.8.20 for lessee-paid costs. [842-10-65-1(u)(1)]

13B.8.40 Derecognition of the existing build-to-suit assets and liabilities occurs regardless of whether the transaction qualified as a sale-leaseback transaction under Topic 840.



### Question 13B.8.10 Lease classification for build-to-suit leases on transition

#### On transition, how is lease classification assessed when the lessee was considered the owner of the asset under construction under the Topic 840 build-to-suit requirements?

**Background:** For the purpose of this question, Lessee LE was deemed the accounting owner of an asset under construction in a build-to-suit lease arrangement under Topic 840. The lease inception date was January 1, 2016. The lease commencement date (i.e. the end of the construction period) was January 1, 2018. In accordance with paragraph 13B.8.20, the lessee derecognizes the underlying asset (see Question 13B.8.20) and related financial liability as of the date of initial application.

Two scenarios are discussed in this question.

1. There was a successful sale-leaseback under Topic 840 at January 1, 2018 (or any later date before January 1, 2019).
2. The lessee had a failed sale-leaseback at January 1, 2018 and continues to recognize the constructed asset and a financial liability at the effective date of Topic 842 (e.g. January 1, 2019).

**Interpretive response:** If the package of transition practical expedients is not elected, classification of the lease in either background scenario will be assessed as of the lease commencement date (January 1, 2018). This is consistent with the date any other lease is assessed for classification when the package of practical expedients is not elected (see Question 13B.2.20).

In contrast, if the package of transition practical expedients is elected, the answer is more complex.

- In Scenario 1, a lease exists under Topic 840 before the effective date, the classification of which would have been assessed as of lease inception under Topic 840. Because the package of practical expedients was elected, we do not believe the lessee should reassess the lease classification that was determined at lease inception.
- In Scenario 2, in the absence of specific guidance in Topic 842, we believe it would be acceptable for the lessee to assess classification of the lease as of either:
  - the commencement date of January 1, 2018, using the lease classification guidance in Topic 842; or
  - the inception date of January 1, 2016, using the lease classification guidance in Topic 840.

We believe the first approach is acceptable, even though the package of practical expedients has been elected, because there was no 'existing lease' that had previously been classified under Topic 840. We believe the second approach is acceptable because election of the package of transition practical expedients effectively grandfathered the legacy Topic 840 classification guidance, which required lease classification to be assessed as of lease inception. We believe the chosen approach should be used consistently in all similar circumstances.

## Question 13B.8.20



### Lessee-paid costs included in existing build-to-suit assets

**If the carrying amount of a build-to-suit asset includes lessee-paid costs, should those amounts be written off at the 'later of' date?**

**Background:** For purposes of this question, the lessee was considered to be the owner of the construction project under Topic 840; as a result, it has recognized assets and liabilities associated with the construction. The transition provisions of Topic 842 require the lessee to remove any assets and liabilities still recorded at the 'later of' date solely as a result of being the accounting owner of the construction project under Topic 840 – unless the asset remains under construction at the effective date and the lessee is the accounting owner of the construction project under Topic 842 (see section 13B.8.4).

Assume the lessee paid the lessor or a third-party amounts during the construction period that, apart from being considered the owner of the construction project, would have been recognized by the lessee as an asset.

For example, the carrying amount of the build-to-suit asset may include amounts paid by the lessee for:

- construction of the lessor's owned asset or for lessor-owned leasehold improvements; and/or
- lessee-owned leasehold or property improvements.

Question 5.4.80 addresses determining the accounting owner of leasehold improvements.

**Interpretive response:** It depends on what the accounting for the payments would have been until the transition date absent the previous build-to-suit conclusion under Topic 840 that the lessee was the accounting owner of the construction project.

The lessee starts by determining the appropriate lease classification (see Question 13B.8.10). Next, the lessee determines:

- what the appropriate accounting treatment for those costs would have been at the time the costs were incurred; and
- the subsequent accounting for those costs between the date they were incurred and the transition date.

Key considerations generally include whether the amounts paid by the lessee are 'lease payments,' or instead are payments for lessee-owned leasehold or property improvements.

### Operating lease classification

#### Lessor was accounting owner

If the *lessor* was the accounting owner of the underlying asset or of a leasehold or property improvement paid for by the lessee under an operating lease, amounts paid by the lessee to construct the lessor-owned asset or lessor-owned improvement would have been accounted for as part of the 'minimum lease payments' under Topic 840.

For example, if the lessee paid \$100,000 of the costs to construct the lessor-owned underlying asset during the construction period, absent the build-to-suit accounting, that amount would have been accounted for as a lease prepayment. Therefore, when accounting for the lease in transition, the lessee determines how much of the prepayment that would have existed absent the build-to-suit accounting would be unamortized at the transition date. The lessee then accounts for the unamortized prepayment based on the Topic 842 lessee transition requirements (see paragraph 13B.3.50).

#### Lessee was accounting owner

If the *lessee* was the accounting owner of leasehold or property improvements, absent build-to-suit accounting, the lessee would have recognized the leasehold or property improvements as separate items of property, plant and equipment. The lessee would have amortized the cost of the improvements over the shorter of the (1) non-cancellable period of the lease plus renewal periods reasonably assured to be exercised or (2) useful life of the improvements. Therefore, in transition, the lessee should continue to recognize PP&E with a carrying amount equal to what the unamortized carrying amount of the

improvements would have been had Topic 840 build-to-suit accounting never applied.

For example, assume the lessee paid \$100,000 for leasehold improvements for which it was the accounting owner. The lessee recognized those costs as part of the cost of the building and was depreciating them over the 30-year useful life of the building. Absent build-to-suit accounting, the amortization period for the leasehold improvements may have been considerably shorter – e.g. if the non-cancellable period of the lease was 15 years and the lessee was not reasonably assured of exercising an option to extend the lease. In that circumstance, the amount that should remain recognized at the transition date is the amount that would be unamortized had the amortization period of the leasehold improvements always been 15 years.

#### **Capital/finance lease classification**

Absent the build-to-suit accounting, payments to a third party for leasehold or property improvements, or to the lessor before lease commencement, including during the construction period, may have been capitalized as part of the cost of the capital lease asset.

Under Topic 842, the carrying amount of the capital lease asset immediately before the transition date becomes the carrying amount of the new finance lease ROU asset in transition (see paragraph 13B.3.100). Therefore, at the Topic 842 transition date, the lessee would capitalize the remaining unamortized amount of these costs (previously included in property, plant and equipment under Topic 840) into the new finance lease ROU asset.

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### **13B.8.2 Evaluating previous build-to-suit conclusions**

13B.8.50 A lessee is not required to reevaluate whether it would have been the accounting owner of an asset under construction in accordance with Topic 842 unless construction of the asset is in progress at the effective date. This is regardless of whether the lessee was the accounting owner of the asset under Topic 840. [842-10-65-1(u)]

13B.8.60 If a lessee is determined to be the accounting owner of an asset under construction as of the effective date for which it was *not* the accounting owner under Topic 840, it will recognize the assets and liabilities arising from being the accounting owner of an asset under construction at the later of (1) the beginning of the earliest period presented, or (2) the date it becomes the accounting owner of the asset under construction based on the guidance in Topic 842. The lessee will account for the assets after the effective date using the Topic 842 sale-leaseback guidance.



## Observation

### Build-to-suit transition

#### **Control guidance applies only on or after the effective date**

13B.8.70 The changes to the sale-leaseback guidance in Topic 842 will make it easier for a lessee that is the accounting owner of an asset under construction to derecognize the underlying asset at the end of the construction period.

13B.8.80 We believe the Board did not intend for a lessee to look back to periods before the effective date of Topic 842 to determine whether it would have been the accounting owner of an asset under construction. This intention would be inconsistent with much of the Board's rationale for its transition approach. It would also appear to be at odds with the guidance on sale-leaseback transactions that says the lessee does not reconsider whether a successful sale that occurred before the effective date would have also been successful under Topic 842.

13B.8.90 Instead, Topic 842 requires that the lessee consider whether it is the owner of an asset under construction only if construction is ongoing at the effective date.

#### **Topic 842 does not appear to prohibit reevaluation of ownership if the lessee was not the accounting owner under Topic 840**

13B.8.100 The transition guidance for existing build-to-suit assets and liabilities appears to preclude continued recognition of build-to-suit assets and liabilities on the balance sheet when construction is complete by the effective date, even if the lessee would have been the accounting owner of the underlying asset under Topic 842.

13B.8.110 However, because the transition guidance is silent, we believe it does not prohibit a lessee from evaluating under Topic 842 whether it was the accounting owner of an asset for which construction was complete by the effective date and for which it was *not* the accounting owner under Topic 840.

13B.8.120 We expect it to be rare that a lessee would choose to voluntarily make this evaluation. However, if it does, we believe it should recognize the assets and liabilities arising from being the accounting owner of an asset under construction at the later of (1) the beginning of the earliest period presented, or (2) the date it becomes the accounting owner of the asset under construction. The lessee will account for the transaction from the recognition date using the Topic 842 sale-leaseback guidance.

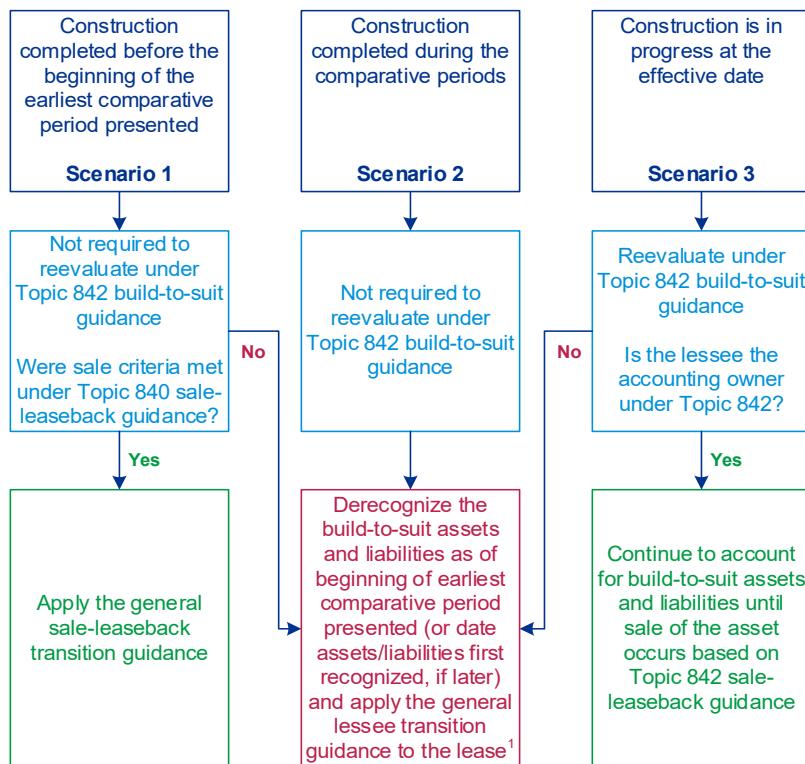
## **13B.8.3 Build-to-suit arrangements accounted for as successful sale-leaseback transactions**

13B.8.130 If the construction period ended before the beginning of the earliest period presented, and the transaction qualified for sale-leaseback accounting under Topic 840 before that date, the lessee only accounts for a lease because the build-to-suit assets and liabilities would already have been derecognized. The lessee applies the transition requirements in the same manner as it does for other sale-leaseback transactions in transition. For further discussion of the

sale-leaseback transition provisions of Topic 842, see section 13B.7.  
[842-10-65-1(u)(2)]

### 13B.8.4 Lessee was the accounting owner under Topic 840

13B.8.140 The following diagram summarizes the transition requirements for a number of potential build-to-suit transition scenarios when the lessee was the accounting owner under Topic 840.



Note:

- See section 13B.3 for discussion of the lessee transition provisions of Topic 842.

#### **Scenario 1: Construction completed before the beginning of the earliest comparative period presented**

13B.8.150 The lessee does not evaluate whether it would have been the accounting owner of the asset under Topic 842 because construction was completed before the effective date. The lessee's transition accounting will depend on whether the Topic 840 sale criteria for a sale-leaseback transaction were met.

13B.8.160 When the Topic 840 sale criteria for a sale-leaseback transaction were met before the beginning of the earliest comparative period presented, the lessee does not reevaluate that conclusion, and applies the Topic 842 transition guidance to the sale-leaseback.

13B.8.170 When the construction period ended before the beginning of the earliest comparative period presented, but the Topic 840 sale criteria for a sale-

leaseback transaction were not met, the lessee derecognizes the build-to-suit assets and liabilities that were recognized under Topic 840 as of the beginning of the earliest comparative period presented. Any difference is recorded as an adjustment to equity at that date (after consideration of the guidance in Question 13B.8.20). The lessee then applies the general lessee transition guidance to the lease.

### ***Scenario 2: Construction completed during the comparative periods***

13B.8.180 The lessee does not evaluate whether it would have been the accounting owner of the asset under construction based on the new leases guidance because the construction was completed before the effective date.

13B.8.190 Therefore, the lessee derecognizes the build-to-suit assets and liabilities that it recognized under Topic 840 as of the later of (a) the beginning of the earliest comparative period presented, and (b) the date the lessee was determined to be the accounting owner of the underlying asset. Any difference is recorded as an adjustment to equity at that date. The lessee then applies the general lessee transition guidance to the lease.

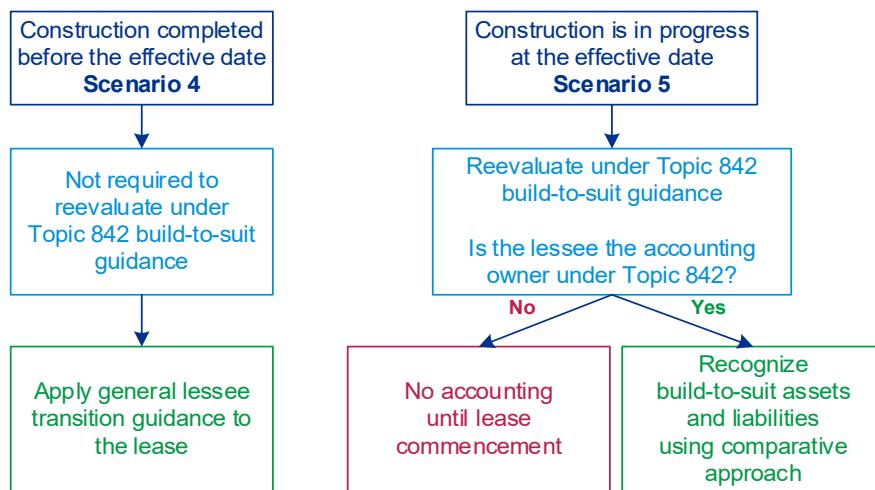
### ***Scenario 3: Construction is in progress at the effective date***

13B.8.200 The lessee reevaluates whether it is the accounting owner of the asset under Topic 842 at the effective date. If it is considered the accounting owner, the lessee continues to recognize the construction-in-progress assets and liabilities that arose because the lessee is the accounting owner until they qualify for derecognition under the sale-leaseback requirements of Topic 842.

13B.8.210 If the lessee is not considered the accounting owner, it derecognizes the build-to-suit assets and liabilities that it recognized under Topic 840 as of the later of (1) the beginning of the earliest comparative period presented, or (2) the date the lessee was determined to be the accounting owner of the asset under Topic 840. The lessee records the difference as an adjustment to equity at that date (after consideration of the guidance in Question 13B.8.20). The lessee then applies the general lessee transition guidance to the lease.

## **13B.8.5 Lessee was not the accounting owner under Topic 840**

13B.8.220 The following diagram summarizes our understanding of the transition requirements for potential build-to-suit transition scenarios when the lessee was not the accounting owner under Topic 840.



### **Scenario 4: Construction completed before the effective date**

13B.8.230 The lessee is not required to evaluate whether it would have been the accounting owner of the asset while it was under construction in accordance with Topic 842. However, we do not believe the transition guidance prohibits a lessee from making this evaluation (see paragraph 13B.8.110).

13B.8.240 If the lessee does not undertake this evaluation, it applies the general lessee transition requirements to the lease.

13B.8.250 In the unlikely event that the lessee chooses to evaluate whether it would have been the accounting owner under Topic 842, it should recognize the assets and liabilities arising from being the accounting owner of the asset under construction at the later of (1) the beginning of the earliest period presented, or (2) the date it was determined to be the accounting owner of the asset under construction under Topic 842. The lessee would account for the transaction in accordance with the sale-leaseback guidance in Topic 842 from the date of recognition.

### **Scenario 5: Construction is in progress at the effective date**

13B.8.260 The lessee evaluates whether it controls, at the effective date of Topic 842, an underlying asset a developer is presently constructing or designing that it will subsequently lease. If it controls the underlying asset, it will be the accounting owner under Topic 842.

13B.8.270 The lessee recognizes the assets and liabilities resulting from the conclusion that it is the accounting owner of the asset under construction at the later of (1) the beginning of the earliest comparative period presented, or (2) the date the lessee was determined to be the accounting owner of the asset under construction under Topic 842. The lessee will account for the transaction in accordance with the sale-leaseback guidance in Topic 842 from the effective date.

13B.8.280 If the lessee was not the accounting owner of the asset under either Topic 840 or Topic 842, then the lessee applies the requirements of Topic 842 at lease commencement.



## Observation

### **Lessees with build-to-suit leases may early adopt**

13B.8.290 In many cases, the transition provisions in Topic 842 permit (or require) lessees to derecognize build-to-suit assets and liabilities that were previously recognized under Topic 840, including such assets and liabilities that remained recognized because of the Topic 840 sale-leaseback requirements.

13B.8.300 In addition, the changes to the sale-leaseback guidance in Topic 842 make it easier for many lessees to derecognize build-to-suit assets and liabilities at the end of the construction period. Fewer build-to-suit arrangements for which a lessee is determined to be the accounting owner will result in failed sales.

13B.8.310 Therefore, some lessees for which these factors are relevant may early adopt Topic 842.

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## Observation

### **SAB Topic 11.M disclosure of impact on future periods**

13B.8.320 SEC registrants are required to evaluate new accounting standards that they have not yet adopted and to disclose their potential material effects. These disclosures generally should include a discussion about the effect that adoption is expected to have on the financial statements, unless this is not known or reasonably estimable. [\[SAB Topic 11.M\]](#)

13B.8.330 As discussed in paragraph 13B.8.10, on transition a lessee may derecognize significant property, plant and equipment and debt obligations that originally arose from build-to-suit lease arrangements. In their place, the lessee may recognize ROU assets and lease liabilities for the lease of the constructed assets.

13B.8.340 If this is the case for a lessee, among other disclosures it should likely provide in accordance with [SAB Topic 11.M](#), it should disclose these facts and provide a quantification of the related amounts. If precise quantification of the amounts is not yet practicable, a range may be provided. We believe the SEC generally expects that a lessee will refine its estimates (i.e. narrow the ranges previously provided) as the effective date approaches, and that it will not be acceptable for an entity to provide 'boilerplate' disclosures while only stating that it is continuing to evaluate the effect of Topic 842.

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## 13B.9 Previous business combinations



### Excerpt from ASC 842-10

#### 65 Transition and Open Effective Date Information

##### General

> Transition Related to Accounting Standards Updates No. 2016-02, *Leases (Topic 842)*, No. 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*, No. 2018-10, *Codification Improvements to Topic 842, Leases*, No. 2018-11, *Leases (Topic 842): Targeted Improvements*, No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, 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*, No. 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*, No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*, No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*, and No. 2023-01, *Leases (Topic 842): Common Control Arrangements*

**65-1** The following represents the transition and effective date information related to Accounting Standards Updates No. 2016-02, *Leases (Topic 842)*, No. 2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*, No. 2018-10, *Codification Improvements to Topic 842, Leases*, No. 2018-11, *Leases (Topic 842): Targeted Improvements*, No. 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, 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*, No. 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*, No. 2021-05, *Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments*, No. 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*, and No. 2023-01, *Leases (Topic 842): Common Control Arrangements*: [Note: See paragraph 842-10-S65-1 for an SEC Staff Announcement on transition related to Update 2016-02.]

##### Amounts previously recognized in respect of business combinations

- 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).

13B.9.10 If an entity previously recognized an asset (liability) relating to favorable (unfavorable) terms of an operating lease acquired as part of a business combination: [842-10-65-1(h); 65-1(w)]

- a **lessee** derecognizes that asset (liability), and adjusts the carrying amount of the ROU asset recognized on transition by a corresponding amount.
- a **lessor** derecognizes that asset (liability) only if it arises from a sales-type or direct financing lease, and makes a corresponding adjustment in accordance with paragraph 842-10-65-1(w).

13B.9.20 A favorable lease asset or unfavorable lease liability associated with an operating lease is not written off in transition by lessors. Lessors will continue to recognize such favorable lease assets or unfavorable lease liabilities even after the adoption of the amendments to Topic 805 (business combinations) included in ASU 2016-02; for a discussion about leases acquired in a business combination or asset acquisition, see chapter 11. [842-10-65-1(h)(1)]



### Observation

#### **Impact of previously recognized favorable lease asset or unfavorable lease liability on lessee's subsequent accounting**

13B.9.30 Topic 842 does not prescribe or illustrate the subsequent accounting for a lease of a lessee that, at the transition date, is affected by a previously recognized favorable lease asset or unfavorable lease liability, other than to say that the asset or liability is written off as an adjustment to the transition date ROU asset. However, we believe that:

- a favorable lease asset would affect the accounting for the lease on and after the transition date in the same manner as initial direct costs – i.e. it would increase the lessee's ROU asset recognized at the transition date; and
- an unfavorable lease liability would affect the accounting for the lease after the transition date in the same manner as a lease incentive – i.e. it would decrease the lessee's ROU asset recognized at the transition date.



### Question 13B.9.10

#### **(Un)favorable contract (liabilities) assets for contracts not accounted for as leases under Topic 840**

#### **How should a lessee account for a favorable (unfavorable) contract asset (liability) when a non-lease contract is reassessed as a lease on transition to Topic 842?**

**Background:** Assume that Company AR acquired Company AE before either entity adopted Topic 842. As part of AR's acquisition accounting, it recorded either a favorable contract intangible asset or an unfavorable contract liability for an existing service contract for which AE was the customer and had appropriately determined the contract was not a lease under Topic 840.

AR does not elect the transition package of practical expedients (see section 13B.2) in transitioning to Topic 842, and therefore reassesses the AE contract against the Topic 842 lease definition. Based thereon, the AE contract meets the definition of a lease.

In this situation, the question arises about how to account for the remaining favorable contract intangible asset or unfavorable contract liability on transition, noting that lessees no longer recognize either for leases after the adoption of Topic 842 (see paragraph 11.1.10), and in transition derecognize any such assets or liabilities for existing operating leases as an adjustment to the new ROU asset.

**Interpretive response:** We believe the lessee should derecognize the existing contract asset (liability) at the transition date – i.e. the later of (1) the beginning of the earliest period presented in the financial statements in which Topic 842 is initially applied, and (2) the acquisition date, with a corresponding adjustment to the ROU asset.

# Topic 842 Glossary



## Excerpts from ASC 842

### 20 Glossary

#### Acquiree

The **business** or **businesses** that the **acquirer** obtains control of in a **business combination**. This term also includes a nonprofit activity or business that a not-for-profit acquirer obtains control of in an **acquisition by a not-for-profit entity**.

#### Acquirer

The entity that obtains control of the **acquiree**. However, in a **business combination** in which a **variable interest entity** (VIE) is acquired, the primary beneficiary of that entity always is the acquirer.

#### Acquisition by a Not-for-Profit Entity

A transaction or other event in which a not-for-profit acquirer obtains control of one or more nonprofit activities or businesses and initially recognizes their assets and liabilities in the acquirer's financial statements. When applicable guidance in Topic 805 is applied by a **not-for-profit entity**, the term **business combination** has the same meaning as this term has for a for-profit entity. Likewise, a reference to business combinations in guidance that links to Topic 805 has the same meaning as a reference to acquisitions by not-for-profit entities.

#### Advance Refunding

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.

#### Business

Paragraphs 805-10-55-3A through 55-6 and 805-10-55-8 through 55-9 define what is considered a business.

#### Business Combination

A transaction or other event in which an **acquirer** obtains control of one or more **businesses**. Transactions sometimes referred to as true mergers or mergers of equals also are business combinations. See also **Acquisition by a Not-for-Profit Entity**.

#### Change in Accounting Estimate

A change that has the effect of adjusting the carrying amount of an existing asset or liability or altering the subsequent accounting for existing or future assets or liabilities. A change in accounting estimate is a necessary consequence of the assessment, in conjunction with the periodic presentation of financial statements, of the present status and expected future benefits and obligations associated with assets and liabilities. Changes in accounting

estimates result from new information. Examples of items for which estimates are necessary are uncollectible receivables, inventory obsolescence, service lives and salvage values of depreciable assets, and warranty obligations.

### **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.

### **Consideration in the Contract**

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

### **Contract**

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

### **Corporate Joint Venture**

A corporation owned and operated by a small group of entities (the joint venturers) as a separate and specific business or project for the mutual benefit of the members of the group. A government may also be a member of the group. The purpose of a corporate joint venture frequently is to share risks and rewards in developing a new market, product or technology; to combine complementary technological knowledge; or to pool resources in developing production or other facilities. A corporate joint venture also usually provides an arrangement under which each joint venturer may participate, directly or indirectly, in the overall management of the joint venture. Joint venturers thus have an interest or relationship other than as passive investors. An entity that is a subsidiary of one of the joint venturers is not a corporate joint venture. The ownership of a corporate joint venture seldom changes, and its stock is usually not traded publicly. A noncontrolling interest held by public ownership, however, does not preclude a corporation from being a corporate joint venture

### **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) and is not an operating lease in accordance with paragraph 842-10-25-3A.

### **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.

**Initial Direct Costs**

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

**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.

### **Joint Venture**

An entity owned and operated by a small group of businesses (the joint venturers) as a separate and specific business or project for the mutual benefit of the members of the group. A government may also be a member of the group. The purpose of a joint venture frequently is to share risks and rewards in developing a new market, product, or technology; to combine complementary technological knowledge; or to pool resources in developing production or other facilities. A joint venture also usually provides an arrangement under which each joint venturer may participate, directly or indirectly, in the overall management of the joint venture. Joint venturers thus have an interest or relationship other than as passive investors. An entity that is a subsidiary of one of the joint venturers is not a joint venture. The ownership of a joint venture seldom changes, and its equity interests usually are not traded publicly. A minority public ownership, however, does not preclude an entity from being a joint venture. As distinguished from a **corporate joint venture**, a joint venture is not limited to corporate entities.

### **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.

**Lease Term**

The noncancelable 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.

## 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:

- 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.

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:

- a. The minimum rental payments called for by the lease over the lease term.
- b. 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.
- c. 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.
- d. 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.
- e. 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 accrueable.

### **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.

### **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.

### **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 a 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 and is not an operating lease in accordance with paragraph 842-10-25-3A.

**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.

### **Useful Life**

The period over which an asset is expected to contribute directly or indirectly to future cash flows.

### **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.

### **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.

# Index of changes

This index lists the significant additions and changes made in this edition to assist you in locating recently added or updated content. New Questions and Examples added in this edition are identified throughout the Handbook with \*\* and items that have been significantly updated or revised are identified with #.

## 3. **Definition of a lease**

### Question

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## 4. **Separating components of a contract**

### Question

4.4.17 Changes to the election of a practical expedient \*\*

## 6. **Lessee accounting**

### Questions

6.2.26 Lease classification – applying the present value test for TRAC leases \*\*

6.9.15 Change in approach used to determine classification of lease liabilities \*\*

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7.7.40 Presentation and classification of assets \*\*

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### Question

8.2.15 Sublessor measurement of a sales-type or direct financing sublease \*\*

**9. Sale-leaseback accounting**

Example

- 9.3.20 Failed sale-leaseback transaction – repurchase option reasonably certain to be exercised (seller-lessee accounting) #

**10. Income taxes**

Example

- 10.1.20 Deferred tax measurement of operating leases under Topic 842 (lessee) #

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- Transfers and servicing of financial assets

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We would like to acknowledge the efforts of the main contributors to this edition:

[Kimber Bascom](#)

[Amy Luchkovich](#)

[Michelle Massey](#)

[Scott Muir](#)

[Jess Munday](#)

[Landon Westerlund](#)

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