# Scope and scope exceptions

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

## 1A Amendments to ASC 842 (updated July 2024)

Common Control Arrangements (ASU 2023-01)

The FASB issued Accounting Standards Update (ASU) 2023-01, *Leases (Topic 842): Common Control Arrangements*, which amended ASC 842 to allow entities other than public business entities, not-for- profit conduit bond obligors or employee benefit plans that file or furnish financial statements with the Securities and Exchange Commission (i.e., private companies and certain not-for-profit entities) to elect a practical expedient to use the written terms and conditions (rather than the legally enforceable terms) of a common control arrangement to determine whether a lease exists and to classify and account for the lease. The practical expedient may be elected on an arrangement-by-arrangement basis.

ASU 2023-01 also requires all lessees, including public business entities, to amortize leasehold improvements associated with common control leases over their useful life to the common control group, as long as the lessee controls the use of the underlying asset through a lease. Lessees are also required to account for the leasehold improvements as a transfer of assets between entities under common control through an adjustment to equity (or net assets for not-for-profit entities) when the lessee no longer controls the use of the underlying asset.

This guidance is effective for fiscal years beginning after 15 December 2023, including interim periods within those fiscal years. Early adoption is permitted for financial statements that have not been made available for issuance in any annual or interim period as of the beginning of the related fiscal year.

Entities that adopt ASU 2023-01 after they have adopted ASC 842 can apply this portion of the ASU either (1) prospectively to arrangements that commence or are modified on or after the date that the entity applies the new guidance or (2) retrospectively to the beginning of the period ASC 842 was first applied for arrangements that exist at the date of adoption of this ASU.

When electing this practical expedient, entities are permitted to document existing unwritten terms and conditions of common control arrangements before the date on which the entity’s first interim (if applicable) or annual financial statements are available to be issued.

In the year of adoption, entities are required to provide certain transition disclosures under ASC 250 based on the transition method elected.

ASC 842-10-65-7 does not provide guidance for a transition scenario when the reporting entity (1) has already adopted ASC 842, (2) elects to retrospectively apply the practical expedient to the beginning of the period when ASC 842 was applied and (3) has an arrangement that was previously a lease but is no longer a lease after applying the practical expedient. In this scenario, we believe that the derecognition guidance discussed in section 9.1.1 should be applied.

Entities that adopt ASU 2023-01 after adopting ASC 842 may apply this portion of the ASU using one of the following methods:

* Prospectively to all new leasehold improvements recognized on or after the date an entity first applies the new guidance
* Prospectively to all new and existing leasehold improvements recognized on or after the date an entity first applies new guidance, with the remaining balance of existing leasehold improvements amortized over their remaining useful life to the common control group (i.e., in a manner similar to a change in accounting estimate)
* Retrospectively to the beginning of the period in which ASC 842 was first applied, with any leasehold improvement amortization or impairment that would not have been required by this ASU recognized through 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 the year of adoption, lessees are required to provide certain transition disclosures under ASC 250 based on the transition method elected.

## Scope and scope exceptions (updated July 2024)

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

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

*(‘build-to-suit’ transactions)*)

Question 1-1 Should media and entertainment (M&E) companies apply ASC 842 when using equipment and/or facilities owned by another party to produce a film or television series in the scope of ASC 926? (added July 2024)

M&E entities often use equipment and/or facilities owned by another party to produce a film or television series and generally account for the costs of doing so under ASC 926, *Entertainment — Films*. However, ASC 926 states that this guidance is incremental to other topics of US GAAP. Therefore, we believe that arrangements involving the use of equipment and/or facilities to produce a film or television series must first be evaluated to determine whether they are or contain a lease in accordance with ASC 842.

### Service concession arrangements

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

### Applicability to federal, state and local governmental units (updated July 2024)

GASB Statement No. 87, which is applicable to state and local governments, provides a single approach for state and local governments to account for and report leases based on the principle that leases are financings of the right to use an underlying asset. The guidance applies to lease contracts for nonfinancial assets, including vehicles, heavy equipment and buildings, but does not apply to nonexchange transactions, such as donated assets, and leases of intangible assets, such as patents and software licenses.

For federal government entities, Statement of Federal Financial Accounting Standards (SFFAS) 54: *Leases* provides guidance on accounting for leases by lessors and lessees. See our Technical Line, [***Navigating***](https://www.ey.com/en_us/technical/accountinglink/technical-line-navigating-the-requirements-of-the-leases-guidance-for-federal-lessors-and-lessees)[***the requirements of the leases guidance for federal lessors and lessees***](https://www.ey.com/en_us/technical/accountinglink/technical-line-navigating-the-requirements-of-the-leases-guidance-for-federal-lessors-and-lessees), for further discussion.

### Land easements

Land easements are rights to use, access or cross another entity’s land for a specified purpose. For example, a land easement might be acquired for the right to construct and operate a pipeline or other asset (e.g., telecommunication cables) over, under or through an existing area of land or body of water while allowing the landowner continued use of the land for other purposes (e.g., farming), as long as the landowner does not interfere with the rights conveyed in the land easement. A land easement may be perpetual or term based, provide for exclusive or nonexclusive use of the land, and may be prepaid or paid over a defined term.

Perpetual easements are outside the scope of ASC 842, as the definition of a lease requires the contract to be for a period of time. Therefore, entities must carefully evaluate easement contracts to determine whether the contract is perpetual or for a period of time. Examples of contracts that may appear perpetual but are term based include:

* Very long-term contracts (e.g., the FASB indicated in the Background Information and Basis for Conclusions (BC 113) of ASU 2016-02 that very long-term leases of land (e.g., 999 years) are in the scope of ASC 842)
* Contracts with a stated, noncancelable lease term that “automatically renews” if the lessee pays a

periodic renewal fee are in-substance fixed term contracts with optional renewal periods

When determining whether a contract for a land easement is a lease, entities will need to assess whether there is an identified asset (i.e., a distinct portion of land) and whether the customer has the right to direct the use of, and obtain substantially all of the economic benefits of, the identified asset throughout the period of use.

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| **Illustration 1-1: Subsurface pipeline land easement** |
| **Scenario A**  Midstream Co. enters into a 20-year contract with Land Owner for the right to bury a 10-inch diameter pipe three feet below the surface of the land. The contract specifies the exact location of the pipe and states that the property subject to the easement is a 10-foot-strip of land, extending five feet on either side of the center line of the pipe. Additionally, the contract provides access rights to Midstream Co. to install and maintain the pipeline for the duration of the contract (20 years). The terms of the contract permit Midstream Co. to use the property for a pipeline. However, Midstream Co. does not have the right to restrict access to the land. Land Owner has the substantive right to access the property above the pipeline and use it for farming, livestock or other purposes as long as that usage does not interfere with Midstream Co.’s use of the subsurface property.  *Analysis:* Midstream Co. determines that the contract includes a single unit of account (i.e., the identified asset is the property through which the pipeline passes). Midstream Co. determines that while it has access rights to the property, it does not have the right to obtain substantially all of the economic benefit of the identified asset, because Land Owner retains rights to economic benefits subject to the identified asset. Therefore, this contract does not contain a lease.  If Land Owner contracts with another third party to use the surface area above the pipeline, Land Owner and the third party would need to evaluate the contract under ASC 842.  **Scenario B**  Assume the same facts as Scenario A, except that the contract also grants Midstream Co. the right to restrict access to the land easement that includes the surface area immediately above the pipeline.  This right allows Midstream Co. to restrict access to the surface area above Midstream Co.’s pipeline  through any methods Midstream Co. deems appropriate, including the use of signage or fencing.  *Analysis:* Midstream Co. determines that the contract includes a single unit of account (i.e., the identified asset is the property through which the pipeline passes). Midstream Co. determines that it has the right to obtain substantially all of the economic benefit of the identified asset. Additionally, Midstream Co. determines that it has the right to direct how and for what purpose the identified asset will be used throughout the period of use. Therefore, this contract contains a lease. |

### Sales with repurchase options

Some arrangements include repurchase provisions, either as a component of a sales contract or as a separate contract that relates to the goods in the original agreement or similar goods. These provisions affect how an entity applies ASC 606’s guidance on control to affected transactions. If the nature of a repurchase provision results in control of a good not transferring to the customer (e.g., a forward or call option that could require or provide the right to the seller to repurchase an asset), the arrangement may be accounted for as a lease under ASC 842. Refer to section 7.3, *Repurchase agreements,* of our Financial reporting developments (FRD) publication, [***Revenue from contracts with customers (ASC 606)***](https://www.ey.com/en_us/technical/accountinglink/financial-reporting-developments---revenue-from-contracts-with-c), for further discussion of repurchase options that may result in an arrangement being accounted for as a lease rather than a sale to a customer.

## Determining whether an arrangement contains a lease

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

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

Refer to section 9.1, *Related-party leasing transactions*, and section 9.1.1, *Practical expedient to use the written terms and conditions of common control arrangement*, for further discussion of considerations associated with related-party leases and or common control leases, respectively.

The following flowchart is included in ASC 842’s implementation guidance (ASC 842-10-55-1) and depicts the decision-making process for determining whether an arrangement is or contains a lease.

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Is there an identified asset?

Consider paragraphs 842-10-15-9 through 15-16. (refer to section 1.2.1, *Identified asset*)

No

Yes

No

Yes

Customer

Does the customer or the supplier have the right to direct how and for what purpose the identified asset is used throughout the period of use? Consider paragraphs 842-10-15-20(a) and 842-10-15-24 through 15-26. (refer to section 1.2.2.2, *Right to direct the use of the identified asset*)

Supplier

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

(refer to section 1.2.2.2, *Right to direct the use of the identified asse*t)

Yes

Does the customer have the right to operate the asset thr he

oughout the period of use without the supplier having t

right to change those operating instructions?

(refer to section 1.2.2.2, *Right to direct the use of the identified asset*)

No

Did the customer design the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use?

(refer to section 1.2.2.2, *Right to direct the use of the identified asset*)

No

Yes

The contract contains a lease.

The contract does not contain a lease.

Does the customer have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use?

Consider paragraphs 842-10-15-17 through 15-19. (refer to section 1.2.2.1*, Right to obtain substantially all of the*

*economic benefits from the use of the identified asset)*

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

### Identified asset

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

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| **Illustration 1-2: Implicitly specified asset** |
| Customer X enters into a five-year contract with Supplier Y for the use of a railcar specifically designed for Customer X. The railcar is designed to transport materials used in Customer X’s production process and is not suitable for use by other customers. The railcar is not explicitly specified in the contract, but Supplier Y owns only one railcar that is suitable for Customer X’s use. If the railcar does not operate properly, the contract requires Supplier Y to repair or replace the railcar. Assume that Supplier Y does not have a substantive substitution right (refer to section 1.2.1.1, *Substantive substitution rights*).  *Analysis*: The railcar is an identified asset. While the railcar is not explicitly specified in the contract (e.g., by serial number), it is implicitly specified because Supplier Y must use it to fulfill the contract. |

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

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

An identified asset also can be a physically distinct portion of a larger asset. Examples include the following:

* A floor of a building
* The “last mile” of a telecommunications network that connects a single customer to a larger network
* A segment of a pipeline that connects a single customer to a larger pipeline (i.e., the segment is used solely by one customer)
* A dedicated production line within a contract manufacturing facility

However, a capacity portion or other portion of an asset that is not physically distinct (e.g., a capacity portion of a fiber optic cable) is not an identified asset unless it represents substantially all of the capacity of the asset and therefore provides the customer with the right to obtain substantially all of the economic benefits from use of the asset.

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| **Illustration 1-3: Identified asset — physically distinct portion of a larger asset** |
| Customer X enters into a 12-year contract with Supplier Y for the right to use three fibers in a fiber optic cable between New York and London. The contract identifies three of the cable’s 20 fibers for use by Customer X. The three fibers are dedicated solely to Customer X’s data for the duration of the contract term. Assume that Supplier Y does not have a substantive substitution right (refer to section 1.2.1.1, *Substantive substitution rights*).  *Analysis:* The three fibers are identified assets because they are physically distinct and explicitly specified in the contract. |

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| **Illustration 1-4: Identified asset — capacity portion of an asset** |
| **Scenario A**  Customer X enters into a five-year contract with Supplier Y for the right to transport oil from Country A to Country B through Supplier Y’s pipeline. The contract provides that Customer X will have the right to 95% of the pipeline’s capacity throughout the term of the arrangement. Supplier Y has no right (substantively or contractually) to connect additional branch lines from the identified pipeline for the benefit of other customers.  *Analysis*: The capacity portion of the pipeline is an identified asset. While 95% of the pipeline’s capacity is not physically distinct from the remaining capacity of the pipeline, it represents substantially all of the capacity of the pipeline and thereby provides Customer X with the right to obtain substantially all of the economic benefits from use of the pipeline.  **Scenario B**  Assume the same facts as in Scenario A, except that Customer X has the right to use 60% of the  pipeline’s capacity throughout the term of the arrangement.  *Analysis*: The capacity portion of the pipeline is not an identified asset because 60% of the pipeline’s capacity is less than substantially all of the capacity of the pipeline. Customer X does not have the right to obtain substantially all of the economic benefits from use of the pipeline. |

Substantially all

The term “substantially all” is not defined in ASC 842. However, entities might refer to the description in ASC 842-10-55-2 of how “substantially all the fair value of the underlying asset” could be evaluated in the context of lease classification. In that paragraph, the FASB states that “one reasonable approach” would be to conclude that “[n]inety percent or more of the fair value of the underlying asset amounts to substantially all the fair value of the underlying asset.” Refer to section 2.8, *Fair value*.

##### Substantive substitution rights (updated August 2023)

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

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

The FASB indicated in the Basis for Conclusions (BC 129) of ASU 2016-02 that the conditions above are intended to differentiate between substitution rights that result in a supplier controlling the use of an asset, rather than the customer, and rights that do not change the substance or character of the contract.

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

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

The requirement that a substitution right must benefit the supplier economically in order to be substantive is a new concept. The FASB indicated in the Basis for Conclusions (BC 130) of ASU 2016-02 that, in many cases, it will be clear that the supplier will not benefit from the exercise of a substitution right because of the costs associated with substituting an asset. The physical location of the asset may affect the costs associated with substituting the asset. For example, if an asset is located at the customer’s premises, the cost associated with substituting it is generally higher than the cost of substituting a similar asset located at the supplier’s premises. However, simply because the cost of substitution is not significant doesn’t mean that the supplier would benefit economically from the right of substitution.

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

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

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

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| **Illustration 1-5: Substitution rights** |
| **Scenario A**  Assume that an electronic data storage provider (supplier) provides services, through a centralized data center, that involve the use of a specified server (Server No. 9). The supplier maintains many identical servers in a single, accessible location and determines, at inception of the contract, that it is permitted to and can easily substitute another server without the customer’s consent throughout the period of use. Further, the supplier would benefit economically from substituting an alternative asset, because doing this would allow the supplier to optimize the performance of its network at only a nominal cost. In addition, the supplier has made clear that it has negotiated this right of substitution as an important right in the arrangement, and the substitution right affected the pricing of the arrangement.  *Analysis:* The customer does not have the right to use an identified asset because, at the inception of the contract, the supplier has the practical ability to substitute the server and would benefit  economically from such a substitution. However, if the customer could not readily determine whether the supplier had a substantive substitution right (e.g., there is insufficient transparency into the supplier’s operations), the customer would presume the substitution right is not substantive and conclude that there is an identified asset.  **Scenario B**  Assume the same facts as in Scenario A except that Server No. 9 is customized, and the supplier does not have the practical ability to substitute the customized asset throughout the period of use. Additionally, it is unclear to the customer whether the supplier has the practical ability to substitute or whether it would benefit economically from sourcing a similar alternative asset.  *Analysis*: Because the supplier does not have the practical ability to substitute the asset, and there is no evidence of economic benefit to the supplier for substituting the asset, the substitution right is non- substantive from the perspective of both the lessee and the lessor. Therefore, Server No. 9 would be an identified asset. In this case, neither of the conditions of a substantive substitution right is met. As a reminder, both conditions must be met for the supplier to have a substantive substitution right. |

Question 1-2 Does a contract contain a lease when the supplier has substitution rights that are not substantive throughout the entire period of use? (added August 2023)

Substitution rights may exist in a contract but may not be substantive through the entire period of the use. Consider a fact pattern in which a customer enters into a 10-year contract with a supplier for 100 similar batteries used in electric buses. The supplier has the practical ability to substitute alternative assets throughout the contract term and would be required to compensate the customer for any revenue lost or costs incurred while the substitution takes place. At inception of the contract, it is expected that the supplier would benefit economically from substituting the battery once it has been used for three years or more but not before.

This fact pattern was submitted to the IFRS Interpretations Committee (IFRS IC) in March 2023. Although this question was submitted to the IFRS IC under IFRS 16, *Leases*, the definition of a lease is the same under IFRS 16 and ASC 842. We should expect a similar answer under ASC 842 in this fact pattern. The IFRS IC noted that the customer is able to benefit from the use of each battery together with a bus that is readily available to it, and each battery is neither highly dependent on, nor highly interrelated with the

other batteries in the contract. The supplier has the practical ability to substitute alternative batteries throughout the period of use. However, because the supplier is not expected to benefit economically from substituting a battery for at least the first three years of the contract, the supplier does not have a substantive substitution right throughout the period of use.

Therefore, in the fact pattern, the IFRS IC concluded that each battery is an identified asset. It follows then, in evaluating whether the contract contains lease, the requirements in ASC 842 need to be applied to assess whether, throughout the period of use, the customer has the right to obtain substantially all the economic benefits from use, and direct the use, of each battery (and therefore has the right to control the use of the underlying asset).

### Right to control the use of the identified asset

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

* The right to obtain substantially all of the economic benefits from the use of the identified asset (refer to section 1.2.2.1, *Right to obtain substantially all of the economic benefits from the use of the identified asset*)
* The right to direct the use of the identified asset (refer to section 1.2.2.2, *Right to direct the use of the identified asset*)

If the customer has the right to control the use of an identified asset for only a portion of the term of the contract, the contract contains a lease for that portion of the term in accordance with ASC 842-10-15-5.

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| **Illustration 1-6: Right to control the use of the identified asset** |
| **Scenario A**  Contractor X enters into a contract with Crane Co. for the exclusive right to use a specific tower crane throughout a three-year period. Crane Co. also provides a crew to operate the crane. The contract does not provide for any substitution rights. Crane Co. prohibits certain uses of the crane (e.g., moving it, using it unsafely) and modifications to the crane.  *Analysis:* Contractor X concludes that it has the right to substantially all of the economic benefits that result from the use of the crane throughout the period of use.  Although Crane Co. provides a crew to operate the crane, Contractor X concludes that it has the right to direct how and for what purpose the crane will be used throughout the period of use (e.g., it directs when the crane operates and what it will lift and can change such decisions). While Crane Co. has the right to prohibit certain uses of the crane and modifications to the crane, those rights are solely to protect its interest in the crane and do not, by themselves, prevent Contractor X from having the right to direct the use of the identified asset.  Because Contractor X has the right to substantially all of the economic benefits from the crane and has the right to direct the use of the crane, Contractor X concludes that it has the right to control the use of the crane.  **Scenario B**  Consumer products entity (CP) enters into a contract with Vendor for a dedicated production line to manufacture one of its store-brand household products for a two-year period. The contract states that CP has the exclusive use of the production line (i.e., Vendor cannot use the production line for other customer orders). |

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| The type of household product is specified in the contract. CP issues instructions to Vendor about the quantity and timing of products to be delivered. If the production line is not producing the household product for CP, it does not operate.  Vendor operates and maintains the production line on a daily basis.  *Analysis:* This contract contains a lease. CP has the right to use the dedicated production line for two years.  There is an identified asset. The dedicated production line is an implicitly identified asset because Vendor has only one line that can fulfill the contract, and Vendor does not have the right to substitute the specified production line.  CP has the right to control the use of the dedicated production line (i.e., the identified asset) throughout the two-year period of use because:   * CP has the right to substantially all of the economic benefits from use of the dedicated production line over the two-year period of use. CP has exclusive use of the dedicated production line; it has rights to all the household product produced throughout the two-year period of use. * CP has the right to direct the use of the dedicated production line. CP makes the relevant decisions about how and for what purpose the production line is used because it has the right to determine whether, when, and how much the production line will produce (i.e., the timing and quantity, if any, of household products produced) throughout the period of use. Because Vendor is prevented from using the production line for another purpose, CP’s decision-making rights about the timing and quantity of household products produced, in effect, determine when and whether the production line produces product.   Although the operation and maintenance of the production line are essential to its efficient use, Vendor’s decisions in this regard do not give it the right to direct how and for what purpose the production line is used. Consequently, Vendor does not control the use of the production line during the period of use. Instead, Vendor’s decisions are dependent on CP’s decisions about how and for what purpose the production line is used.  Determining whether a customer has the right to direct the use of an asset throughout the period of use may require significant judgment. Changes in facts and circumstances may result in a different conclusion. |

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

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

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

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

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

##### Right to direct the use of the identified asset

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

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

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

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

The FASB indicated in the Basis for Conclusions (BC 137) of ASU 2016-02 that decisions about how and for what purpose an asset is used can be viewed as similar to the decisions made by a board of directors. Decisions made by a board of directors about the operating and financing activities of an entity are generally the most relevant decisions rather than the actions of individuals in implementing those decisions.

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

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

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

* Maintaining the asset
* Operating the asset

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

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

We believe that the assessment of whether a contract is or contains a lease will be straightforward in most arrangements. However, judgment may be required in applying the definition of a lease to certain arrangements. For example, in contracts that include significant services, we believe that determining whether the contract conveys the right to direct the use of an identified asset may be more complex. Examples of such contracts may include third-party manufacturing, warehousing, transportation, advertising or information technology arrangements. Evaluating whether these arrangements contain a lease may require judgment.

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

In some cases, it will not be clear whether the customer has the right to direct the use of the identified asset. This could be the case when the most relevant decisions about how and for what purpose an asset is used are predetermined by contractual restrictions on the use of the asset (e.g., the decisions about the use of the asset are agreed to by the customer and the supplier in negotiating the contract, and those decisions cannot be changed). This could also be the case when the most relevant decisions about how and for what purpose an asset is used are, in effect, predetermined by the design of the asset. The FASB indicated in the Basis for Conclusions (BC 138) of ASU 2016-02 that it would expect decisions about how and for what purpose an asset is used to be predetermined in few cases. When decisions about how and for what purpose an asset is to be used are predetermined, a customer has the right to direct the use of an identified asset throughout the period of use when the customer either:

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

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

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

##### Effect of protective rights on the right to direct the use of the identified asset

A right that solely protects the supplier’s interest in the underlying asset, in and of itself, does not prevent the customer from having the right to direct the use of an identified asset. Protective rights typically define the scope of the customer’s right to use the asset without removing the customer’s right to direct the use of the asset. Protective rights are intended to protect a supplier’s interests (e.g., interests in the asset, its personnel, compliance with laws and regulations) and might take the form of a specified maximum amount of asset use (e.g., limits on the number of miles a customer can drive a supplier’s vehicle), a restriction on where an asset may be used or a requirement to follow specific operating instructions.

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| **Illustration 1-7: Right to direct the use of an asset** |
| Customer X enters into a contract with Supplier Y to use a vehicle for a three-year period. The vehicle is identified in the contract. Supplier Y cannot substitute another vehicle unless the specified vehicle is not operational (e.g., it breaks down).  Under the contract:   * Customer X operates the vehicle (i.e., drives the vehicle) or directs others to operate the vehicle (e.g., hires a driver). * Customer X decides how to use the vehicle (within contractual limitations, as discussed below). For example, throughout the period of use, Customer X decides where the vehicle goes as well as when or whether it is used and what it is used for. Customer X can also change these decisions throughout the period of use. * Supplier Y prohibits certain uses of the vehicle (e.g., moving it overseas) and modifications of the vehicle to protect its interest in the asset.   *Analysis*: Customer X has the right to direct the use of the identified vehicle throughout the period of use. Customer X has the right to direct the use of the vehicle because it has the right to change how the vehicle is used, when or whether the vehicle is used, where the vehicle goes and what the vehicle is used for.  Supplier Y’s limits on certain uses for the vehicle and modifications to it are considered protective rights that define the scope of Customer X’s use of the asset but do not affect the assessment of whether Customer X directs the use of the asset. |

### Leases involving joint arrangements

A customer, including a customer that is a joint operation or joint arrangement (collectively referred to as a “joint arrangement” in this section), and a supplier are required to consider whether the customer has the right to control the use of an identified asset to determine whether an arrangement is or contains a lease. Joint arrangements, which are generally not legal entities and are not defined by US GAAP, are common in extractive industries and may be present in other industries.

In a joint arrangement, an operator (e.g., an operator of an oil and gas property) may agree with other parties (i.e., nonoperators in the joint arrangement to which the operator is a party) to perform certain activities necessary to develop or operate the property. The contractual rights and obligations of each party to the arrangements are typically documented through the use of a joint operating agreement. To fulfill its responsibilities, the operator often enters into contracts with third-party suppliers to obtain the use of an asset (e.g., a drilling rig) to perform the activities. Less frequently, the joint arrangement (as a group) may enter into agreements directly with a supplier to use an asset.

Consequently, the customer (i.e., either the operator individually or the joint arrangement as if it were a single customer) and the supplier to each contract will have to carefully evaluate these agreements to determine whether the customer controls the use of an identified asset throughout the period of use.

This assessment will often require two steps when a supplier enters into a contract directly with the operator to use an identified asset, for example:

* Step 1: The supplier and the operator would evaluate whether the operator controls the use of the identified asset, and if so, a right-of-use (ROU) asset and lease liability would generally be recognized by the operator (refer to section 4, *Lessee accounting*).
* Step 2: Next, the operator and the joint arrangement should evaluate whether a sublease exists from the operator to the joint arrangement (as if the joint arrangement were a single customer). If the joint arrangement controls the use of the identified asset under the term of an arrangement between the operator and the joint arrangement, the operator would recognize a sublease to the joint arrangement to the extent of the nonoperators’ interest. The nonoperators to the joint arrangement consider other applicable GAAP to individually account for their interest in the joint arrangement.

Summary of assessment when a supplier enters into a contract directly with the operator to use an identified asset

No

Yes

No

Yes

**A sublease exists from the operator to the joint arrangement**

(section 6, *Subleases*)

* **Operator recognizes a sublease to the joint arrangement**
* **Nonoperators consider other applicable GAAP to individually account for their interest in the joint arrangement**

Operator and nonoperators apply other GAAP to account for the arrangement between the operator and nonoperators

**Does the joint arrangement have the right to control the use of the identified asset under the terms of an arrangement between the operator and the joint arrangement?**

(section 1.2.2, *Right to control the use of the identified asset*)

**The operator and joint arrangement should evaluate whether a sublease exists from the operator to the joint arrangement (as if it were a single customer)** (section 6, *Subleases*)

**A right-of-use asset and lease liability are generally recognized by the operator**

(section 3, *Lease classification*, and section 4, *Lessee accounting*) **Supplier applies lessor accounting based on lease classification** (section 3, *Lease classification*, and section 5, *Lessor accounting*)

Apply other GAAP

**Does the operator have the right to control the use of the identified asset?**

(section 1.2.2, *Right to control the use of the identified asset*)

Summary of assessment when a supplier enters into a contract directly with the joint arrangement to use an identified asset

No

Yes

**A lease exists from the supplier to the joint arrangement**

* **Supplier applies lessor accounting based on lease classification** (section 3, *Lease classification*, and section 5, *Lessor accounting*)
* **Operator and nonoperators consider other applicable GAAP to individually account for their interest in the joint arrangement**

Apply other GAAP

**Does the joint arrangement (as if it were a single customer) have the right to control the use of the identified asset?** (section 1.2.2, *Right to control the use of the identified asset*)

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| **Illustration 1-8: Joint operations** |
| Upstream Co. is designated as the operator for a series of oil and gas properties in the Gulf of Mexico (GOM properties), for which there are three nonoperators. Under the joint arrangement, the nonoperators are limited in their involvement to only making choices about participation in the exploration and development of the property.  To fulfill its responsibilities as operator, Upstream Co. contracts with Rig Co. to lease a fixed platform drilling rig (Rig A) for five years. Upstream Co. enters into the contract with the intention of using Rig A to develop the GOM properties; however, Upstream Co. does not enter into a contract with the joint arrangement (or parties to that operation) for the right to use the asset (i.e., the nonoperators do not have any legally enforceable rights or obligations with respect to Rig A).  *Analysis*  Upstream Co. concludes that it has legally enforceable rights and obligations with Rig Co., and that the contract represents a lease of Rig A. Therefore, Upstream Co. will record 100% of the right-of-use asset and lease liability relating to Rig A.  Upstream Co. and the nonoperators further evaluate the arrangement, noting the following:   * Upstream Co. is contractually permitted to use Rig A for projects unrelated to the joint arrangement, provided Upstream Co. supplies another drilling rig to fulfill its obligation as operator on the GOM properties. * Because the nonoperators are limited in their involvement to making choices about participation in the exploration and development of the property rather than the use of the leased rig, the joint arrangement cannot direct the use of Rig A.   Upstream Co. determines that the agreement with the joint arrangement does not include a sublease of Rig A. Likewise, the nonoperators determine that they are not lessees with respect to Rig A and, therefore, do not recognize any right-of-use asset or lease liability with respect to Rig A. |

## Reassessment of the contract

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

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

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

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

### Identifying and separating lease components of a contract

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

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

If one or both of these criteria are not met, the right to use multiple assets is considered a single lease component. The FASB indicated in the Basis for Conclusions (BC 146) of ASU 2016-02 that the guidance on identifying and separating lease components is similar to the guidance on identifying and separating performance obligations in a revenue contract under ASC 606. Refer to section 4, *Identify the performance obligations in the contract*, of our FRD, [***Revenue from contracts with customers (ASC 606)***](https://www.ey.com/en_us/technical/accountinglink/financial-reporting-developments---revenue-from-contracts-with-c), for additional details.

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

* Lease classification
* The balance sheet presentation of right-of-use assets and lease liabilities
* The timing and classification of expense or income recognition
* The classification of lease payments in the statement of cash flows
* Disclosures in the notes to the financial statements (e.g., disclosure of lease costs, noncash information on lease liabilities, the weighted-average lease term, the discount rate)

The FASB indicated in the Basis for Conclusions (BC 147) of ASU 2016-02 that since land, by virtue of its indefinite economic life, is substantively different from other assets, it should be assessed separately regardless of whether the separate lease component criteria are met.

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

An entity may account for separate lease components (e.g., a group of identical data servers) as a single lease component using a portfolio approach if the leases commence at the same date, the leases are co- terminus and the accounting for the separate lease components as a single lease component does not materially differ from accounting for the separate lease components as multiple lease components. For more information on the portfolio approach, refer to section 4.8.4, *Portfolio approach*, for lessee accounting and section 5.7.4.1, *Portfolio approach*, for lessor accounting.

However, in some circumstances, an entity may need to account for the separate lease components as multiple lease components when:

* Accounting for certain lease modifications (refer to section 4.6, *Lease modifications*, for lessee accounting and section 5.6, *Lease modifications*, for lessor accounting)
* Accounting for asset abandonments (refer to section 4.2.5.3, *Abandonment of ROU assets*, for abandonment of operating lease right-of-use assets and section 4.3.4.3, *Abandonment of ROU assets*, for abandonment of finance lease right-of-use assets)

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

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

Many contracts contain a lease coupled with an agreement to purchase or sell other goods or services (non-lease components). The non-lease components are identified and accounted for separately from the lease component in accordance with other US GAAP (except when a lessee or lessor applies the practical expedient to not separate lease and non-lease components as discussed in sections 1.4.2.3, *Practical expedient to not separate lease and non-lease components — lessees*, and 1.4.2.4, *Practical expedient to not separate lease and non-lease components — lessors*, respectively). For example, the non-lease components may be accounted for as executory arrangements by lessees (customers) or as contracts subject to ASC 606, *Revenue from Contracts with Customers*, by lessors (suppliers). When the respective practical expedient is not applied, non-lease components are accounted for separately from the lease components under ASC 842 even if they would not be treated separately from other promised goods and services in a revenue contract with a customer.

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

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

##### Executory costs

“Executory costs” is not a defined term in GAAP, and in practice the term generally refers to costs related to insurance, taxes and maintenance (and any profit thereon) that will be paid to the lessor. ASC 842 clarifies the accounting for these costs by requiring entities to evaluate whether the costs represent payments for a component of the contract. That is, entities must evaluate whether the payments are for a good or service transferred to the lessee that is separate from the right to use the underlying asset.

Under ASC 842, maintenance activities, including common area maintenance (e.g., cleaning a lobby of a building, removing snow from a parking lot), provided by the lessor are considered non-lease components because they represent goods or services transferred to the lessee separately from the right to use the underlying asset.

Insurance that protects the lessor’s interest in the underlying asset and taxes related to the underlying asset (e.g., real estate taxes on the underlying asset) are not separate components of the contract because they do not transfer a good or service to the lessee that is separate from the right to use the underlying asset. As a result, a lessee will allocate payments for these items to lease and non-lease components, assuming it doesn’t make the accounting policy election to combine the lease and associated non-lease components (refer to section 1.4.2.3, *Practical expedient to not separate lease and non-lease components — lessees*). Lessees also should evaluate whether lease payments made for insurance that protects the lessor’s interest in the underlying asset and taxes relating to such asset are fixed (or in-substance fixed) lease payments or variable lease payments (refer to section 2.4, *Lease payments*).

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

How a lessor accounts for payments for insurance that protects its interest in the underlying asset and real estate taxes related to such asset depends on whether those payments are fixed or variable and whether they are made by the lessee to the lessor as a reimbursement or made directly to a third party on behalf of the lessor (refer to sections 2.4, *Lease payments*, and 1.4.4, *Determining, allocating and reassessing the consideration in the contract — lessors*).

Whether the payments are allocated by a lessor to lease and non-lease components also depends on whether it qualifies for and elects the practical expedient to not separate lease and non-lease components (refer to section 1.4.2.4, *Practical expedient to not separate lease and non-lease components — lessors*, for further guidance on the accounting policy election to combine the lease and associated non-lease components for lessors). If a lessor does not qualify for or elect to apply the practical expedient to not separate lease and non-lease components, it would follow the guidance in ASC 842-10-15-38 through 15-40, which incorporates ASC 606’s allocation guidance. Refer to section 1.4.4.2, *Allocating the consideration in the contract — lessors*.

ASC 842 allows lessors to make an accounting policy election not to evaluate whether sales taxes and similar taxes imposed by a governmental authority on a specific lease revenue-producing transaction and collected by the lessor from the lessee are the primary obligation of the lessor as owner of the underlying

leased asset. A lessor that makes this election must 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 make additional disclosures.

A lessor is required to exclude lessor costs paid directly by a lessee to third parties on the lessor’s behalf from variable payments, but lessor costs that are paid by the lessor and reimbursed by the lessee are required to be included in variable payments. Refer to paragraphs 842-10-55-141 and 55-142 below, which illustrate this concept in a net lease (e.g., the property tax and insurance amounts are not included in the fixed lease payments specified in the contract). Additionally, refer to section 1.4.4, *Determining, allocating and reassessing the consideration in the contract — lessors*, for further discussion.

When lessors allocate variable payments to lease and non-lease components, they are required to follow the recognition guidance in ASC 842 for the lease component and other applicable guidance, such as ASC 606, for the non-lease component. Refer to section 1.4.4.3, *Allocating variable payments — lessors*.

##### Guarantees of performance of underlying asset

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

##### Practical expedient to not separate lease and non-lease components — lessees (updated July 2024)

ASC 842 provides a practical expedient that permits lessees to make an accounting policy election (by class of underlying asset) to account for each separate lease component of a contract and its associated non-lease components as a single lease component. ASC 842 provides this expedient to alleviate concerns that the costs and administrative burden of allocating consideration to separate lease and non-lease components may not be justified by the benefit of more precisely reflecting the right-of-use asset and the lease liability. Furthermore, as indicated in BC 150 of ASU 2016-02, the FASB expects the practical expedient to most often be used when the non-lease components of a contract are not significant when compared to the lease components of a contract. The practical expedient does not allow lessees to account for multiple lease components of a contract (refer to section 1.4.1, *Identifying and separating lease components of a contract*) as a single lease component. Refer to section 4, *Lessee accounting*, for a discussion of measurement of right-of-use assets and lease liabilities.

Lessees that make the accounting policy election to account for a lease component of a contract and its associated non-lease components as a single lease component must assess classification of the lease based on the consideration in the contract for the combined component. A lessee that makes this election would assess whether the present value of the sum of the lease payments for the combined component and any residual value guaranteed by the lessee that is not already reflected in the lease payments equals or exceeds substantially all of the fair value of the underlying asset (refer to section 3.1, *Criteria for lease classification — lessees*).

When a lease includes a non-lease component related to the purchase of inventory, we believe an entity should separate the purchase of inventory from other lease and non-lease components, even if it has elected to apply the practical expedient to the class of underlying asset to which the lease relates. For example, if a contract contains a lease as well as non-lease components related to a service and the purchase of sheet metal to be used in the construction of inventory, we believe the purchase of the sheet metal should be accounted for as a component of inventory rather than together with the lease component as the purchase of a physical good is not a “non-lease component associated with that lease component.” For another example, consider a hospital that enters into a contract with a supplier for both the right to use medical equipment (i.e., a lease component) and to purchase the medical supplies (i.e., non-lease components) necessary to use the equipment. We believe the hospital would allocate consideration in the contract to both the lease of equipment and the purchase of medical supplies. As a result, the hospital would recognize and account for the components separately (e.g., as a lease and purchased inventory), even if the lessee has elected to apply the practical expedient to the class of underlying asset to which the equipment relates.

Questions have arisen about whether this interpretation on purchases of inventory should apply to a contract manufacturing arrangement that contains a lease. It does not apply because in a contract manufacturing arrangement that contains a lease, the lessee generally is not purchasing inventory. Instead, the lessee is producing inventory with the leased assets (e.g., manufacturing facility, identified equipment) and the manufacturing service provided by the contract manufacturer (lessor).

Therefore, when a contract manufacturing arrangement contains a lease, the lessee can make an accounting policy election for that class of underlying asset to not separate the lease component of the contract (e.g., lease of a manufacturing facility, identified equipment) and its associated non-lease components (e.g., manufacturing services). See section 1.4.2.4 for considerations for applying the lessor practical expedient to a contract manufacturing arrangement.

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

##### Practical expedient to not separate lease and non-lease components — lessors

ASC 842 includes an optional practical expedient that allows lessors to elect, by class of underlying asset, to not separate lease and related non-lease components if the non-lease components otherwise would be accounted for in accordance with the revenue standard and both of the following criteria are met:

* The timing and pattern of transfer of the lease component and the associated non-lease component(s) are the same.
* The lease component would be classified as an operating lease if it were accounted for separately.4

Leases with variable lease payments that are not based on an index or rate (e.g., long-term leases of machinery where the consideration in the contracts is determined based on hours used by the lessee) are classified as operating leases if they would have otherwise been classified as sales-type or direct financing leases and the lessor would have recognized a selling loss at lease commencement. As a result, these leases may qualify for the practical expedient. Refer to section 3.2, *Criteria for lease classification — lessors*, for further discussion on the classification of such leases.

If both of the criteria are met and a lessor elects to use the practical expedient, the lessor is required to account for the combined component as a single performance obligation in accordance with ASC 606 if the non-lease component is the predominant component. If the non-lease component is not the predominant component, a lessor applying this practical expedient is required to account for the combined component as an operating lease in accordance with ASC 842.

The decision tree below summarizes the evaluation of whether a lessor can apply the practical expedient not to separate lease and non-lease components:

No

No

The lessor may not combine the lease and non-lease component(s) as a single component.

Is the timing and pattern of transfer of the lease component(s) and the associated non-lease component(s) the same?

Would the non-lease component(s) otherwise be accounted for under ASC 606?

Is the non-lease component(s) the predominant component(s) in the combined component?

Would the lease component(s) be classified as an operating lease, in accordance with ASC 842-10-25-2 through 25-3A, if it were accounted for separately?

Account for the combined component as a single performance obligation in accordance with ASC 606.

Yes

Yes

No

Yes

Yes

No

Account for the combined component as an operating lease in accordance with ASC 842.

ASC 842 does not provide detailed guidance on how to evaluate whether the predominant component is the lease or non-lease component. Likewise, the Basis for Conclusions (BC 35) of ASU 2018-11, *Leases (Topic 842): Targeted Improvements*, says, “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.”

We agree that, in some cases, a reasonable qualitative analysis may provide an adequate basis for conclusions. However, if it is not clear which component (the lease component or related non-lease component(s)) is predominant, we believe some quantitative analysis may be necessary. The extent of the quantitative evaluation would depend on facts and circumstances of each contract.

The practical expedient is elected by class of underlying assets (as an accounting policy election) and is applied to all arrangements in that class of underlying asset that qualify for the expedient. That is, a lessor cannot pick and choose which arrangements to account for under the expedient.

For example, a lessor may have a portfolio of similar lease arrangements (e.g., units in independent living facilities) across multiple geographic areas. If the lessor elects the expedient for a class of underlying assets, it would analyze (qualitatively and/or quantitatively, as applicable) all contracts in that class of underlying assets. This may result in the lease component being the predominant component in some contracts while other contracts involving the same class of underlying assets have the revenue component as the predominant component.

If a contract includes a lease and multiple associated non-lease components, a lessor must combine all components that qualify for the practical expedient and separately account for the components that do not qualify (i.e., those for which the timing and pattern of transfer of the lease and associated non-lease components are not the same). In doing so, the lessor is required to apply the separation and allocation guidance described in section 1.4.4.2, *Allocating the consideration in the contract — lessors*, to the separate components.

The practical expedient does not allow lessors to account for multiple lease components of a contract (refer to section 1.4.1, *Identifying and separating lease components of a contract*) as a single lease component.

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| **Illustration 1-9: Lessor elects practical expedient to not separate non-lease and associated lease components in a gross lease** |
| Lessor owns and operates a multifamily residential building with 12 units. On 1 January 20X8, Lessor and Tenant enter into a 15-month operating lease of a single residential unit in the building. As part of the contract, Lessor is responsible for maintaining the common areas in the building.  The terms of the lease require Tenant to make a fixed monthly payment of $3,000 for use of the residential unit. There are no additional payments for real estate taxes, building insurance or maintenance of the common areas.  *Analysis:* Lessor determines that the contract contains two components: a lease component (i.e., the right to use the residential unit) and a non-lease component (i.e., CAM). Real estate taxes and insurance are not separate components of the contract.  Lessor evaluates whether it can apply the optional practical expedient to not separate the lease and non-lease component in the contract. It first determines that the non-lease component (i.e., CAM) otherwise would be accounted for under the revenue standard and then assesses the criteria for use of the practical expedient:   * Lessor concludes that the timing and pattern of transfer of the right to use the residential space and the transfer of CAM are the same (i.e., the right to use the residential space and CAM transfer to the tenant on a monthly basis over the term of the contract). * Lessor concludes that the right to use the residential space would be classified as an operating lease if it were accounted for separately.   Lessor concludes that it meets the criteria to use the practical expedient. Lessor then evaluates whether CAM is the predominant component in the arrangement. Lessor concludes that CAM is not the predominant component because Tenant is reasonably expected to ascribe more value to the right to use the residential space. Accordingly, Lessor accounts for the combined component as an operating lease in accordance with ASC 842 and provides the required disclosures by class of underlying assets. Lessor applies the expedient to all eligible arrangements in the same class of underlying asset (i.e., all multifamily residential units that it leases). |

Contracts that include the sale of consumables

Lessors may enter into arrangements to provide a lease of equipment along with non-lease components (e.g., training services, maintenance services, supply of consumable products to be used with the leased equipment).

When the lessor recognizes revenue from sales of the consumable products at a point in time (in accordance with ASC 606), the lease component and the non-lease components (i.e., sale of consumable products) do not have the same timing and pattern of transfer. Therefore, if the entity has made an accounting policy election to not separate the lease and non-lease components, the non-lease component relating to the sale of the consumable products is not eligible to be combined with the lease component.

Non-lease component in a contract manufacturing arrangement

In a contract manufacturing arrangement that contains a lease, the contract manufacturer (lessor) is not selling inventory. Instead, it is providing a service of manufacturing goods for the customer (lessee) over a period of time using the leased assets. As such, the associated non-lease component in the arrangement is providing a manufacturing service, not selling inventory, which may affect whether and how the practical expedient for lessors can be applied. See section 1.4.2.3 for considerations for applying the lessee practical expedient to a contract manufacturing arrangement.

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

##### Determining the consideration in the contract — lessees

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

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

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

Consideration in the contract for a lessee

(ASC 842-10-

15-35)

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

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

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##### Allocating the consideration in the contract — lessees

Lessees that do not make an accounting policy election (by class of underlying asset) to use the practical expedient (refer to section 1.4.2.3, *Practical expedient to not separate lease and non-lease components — lessees*) to account for each separate lease component of a contract and its associated non-lease components as a single lease component are required to allocate the consideration in the contract to the lease and non-lease components on a relative standalone price basis. The practical expedient does not allow lessees to account for multiple lease components of a contract as a single lease component.

Lessees are required to use observable standalone prices (i.e., prices at which a customer would purchase a component of a contract separately) when readily available. If observable standalone prices are not readily available, lessees estimate standalone prices, maximizing the use of observable information. A residual estimation approach may be appropriate when the standalone price for a component is highly variable or uncertain.

When variable payments not included in consideration in the contract are recognized, lessees also allocate these amounts between lease and non-lease components on the same basis as the allocation of consideration in the contract. These payments include variable payments not based on an index or rate or the changes in variable payments based on an index or rate after the commencement date of the lease. Refer to sections 4.2.3, *Expense recognition — operating leases*, and 4.3.3, *Expense recognition — finance leases*, for discussion of the timing of recognition of variable lease payments.

Refer to section 1.4.5, *Examples — identifying and separating components of a contract and determining and allocating the consideration in the contract*, for illustrations of how a lessee determines and allocates consideration in a contract, including for arrangements that include variable payments.

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

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| **Illustration 1-10: Allocating contract consideration if a lessee does not elect the practical expedient to combine the lease and non-lease components** |
| On 1 January 20X0, Lessee enters into a three-year lease for office space with Lessor. Under the terms of the agreement, Lessee agrees to pay the following for the right to use the office space:   * A fixed payment payable on 31 December of each year starting at $300,000 and increasing 10% each year * A variable payment per year based on the actual costs Lessor incurs for Lessor’s property taxes and insurance related to the underlying asset and common area maintenance (CAM). Amounts incurred are payable on 31 December of each year.   In this example, the right to use the office space for three years is a lease component, with a standalone price of $800,000. The lease is classified as an operating lease. The CAM services are a non-lease component, with a standalone price of $123,000. Lessee’s payments for Lessor’s real estate taxes  and insurance related to the underlying asset are not components of the contract because they do not represent payment for goods or services, in addition to the right to use the space, transferred to the lessee.  Assume that Lessee incurs no initial direct costs, and its incremental borrowing rate at lease commencement is 4%.  Also, Lessee does not elect the practical expedient to combine the lease and non-lease components. In this example, Lessee allocates the fixed consideration in the contract as follows:   |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | | Component | Relative % | Allocation of fixed consideration | | | | |  |  | Year 1 | Year 2 | Year 3 | Total | | Lease | 86.7% (a) | 260,000 | 286,000 | 315,000 | 861,000 | | CAM | 13.3% (b) | 40,000 | 44,000 | 48,000 | 132,000 | |  | 100% | 300,000 | 330,000 | 363,000 | 993,000 |  1. 800,000 / (800,000 + 123,000) = 86.7% 2. 123,000 / (800,000 + 123,000) = 13.3%   The initial measurement of the right-of-use asset and lease liability is $794,000 using the allocated consideration in the contract of $861,000 discounted using Lessee’s incremental borrowing rate at lease commencement of 4%. Refer to section 4.2, *Operating leases*, for lessee accounting guidance on the initial measurement of operating leases. |

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| **Component** |  | **Relative %** |  | **Allocation of variable payment** |
| Lease |  | 86.7% |  | $ 43,350 |
| CAM |  | 13.3% |  | 6,650 |
|  |  | 100% |  | $ 50,000 |

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| At the end of year one, Lessee pays the annual rental payment of $300,000, of which $260,000 is allocated to the lease component and $40,000 is allocated to CAM services.  Lessee prepares financial statements on an annual basis at the end of the year. At the end of year one, Lessee records the following for the fixed consideration (refer to section 4.2.2, *Subsequent measurement* — *Operating leases*, for further guidance):  Lease liability $ 228,000 (a)  Lease expense 287,000 (b)  Maintenance expense 44,000 (c)  Right-of-use asset $ 255,000 (d)  Cash 300,000 (e)  CAM accrual 4,000 (f)   1. Difference between the initial measurement of the lease liability (and right-of-use asset) at lease commencement ($794,000) and the present value of remaining lease payments at the end of year one ($566,000) 2. Payments allocated to the lease component recognized on a straight-line basis (total consideration in the contract of   $861,000 over three years)   1. Expense attributable to the non-lease component (total CAM expense of $132,000 over three years) 2. Adjustment in (a) of $228,000 plus accrued rent of $27,000, which is the difference between the cash paid for the lease component of $260,000 and straight-line lease rent expense of $287,000 3. Cash payment 4. CAM accrual for the difference between the straight-line expense allocated to the CAM component ($44,000) and the CAM payment ($40,000)   Lessee makes a variable payment of $50,000 at the end of year one based on Lessor’s costs incurred for property taxes, property insurance and CAM services. Lessee allocates variable payments to the lease and non-lease components (i.e., CAM) on the same basis as the initial allocation of the consideration in the contract.  In this example, Lessee allocates the variable payment in the contract as follows:  At the end of year one, Lessee records the following for the variable payment: Lease expense $ 43,350  Maintenance expense 6,650  Cash $ 50,000  Immaterial differences may arise in the recomputation of amounts in the example above due to rounding. |

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| **Illustration 1-11: Allocating contract consideration if a lessee elects the practical expedient to combine lease and non-lease components** |
| Assume the same facts as in Illustration 1-10 except Lessee elects the practical expedient to combine lease and non-lease components. Lessee has concluded that the lease is an operating lease.  In this example, Lessee allocates all of the consideration to the lease component. Therefore, it recognizes all of the fixed consideration in the contract ($993,000) as lease payments.  The initial measurement of the right-of-use asset and lease liability is $916,000 using Lessee’s incremental borrowing rate at lease commencement of 4%. Refer to section 4.2, *Operating leases*, for lessee accounting guidance on the initial measurement of operating leases.  At the end of year one, Lessee pays the annual rental payment of $300,000 and makes a variable payment  of $50,000 based on Lessor’s actual costs incurred for property taxes, property insurance and CAM.  Lessee prepares financial statements on an annual basis at the end of the year. At the end of year one, Lessee records the following for the fixed and variable consideration (refer to section 4.2.2, *Subsequent measurement* — *Operating leases*, for further guidance):  Lease liability $ 263,000 (a)  Lease expense 381,000 (b)  Right-of-use asset $ 294,000 (c)  Cash 350,000 (d)   1. Difference between the initial measurement of the lease liability (and the right-of-use asset) at lease commencement ($916,000) and the present value of remaining lease payments at the end of year one ($653,000) 2. Fixed and variable payments allocated to the lease component; fixed payments recognized on a straight-line basis (total consideration in the contract of $993,000 over three years) plus the variable payment of $50,000 in year one 3. Adjustment in (a) of $263,000 plus accrued rent of $31,000, which is the difference between the cash paid of $350,000 and straight-line lease rent expense of $381,000 4. Cash payment   Immaterial differences may arise in the recomputation of amounts in the example above due to rounding. |

##### Reassessment: determining and allocating the consideration in the contract — lessees

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

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

Refer to section 4.5, *Remeasurement of lease liabilities and right-of-use assets — operating and finance leases,* for further discussion. Lessees are also required to remeasure and reallocate the consideration in the contract on the effective date of a contract modification (i.e., the date the lessor and lessee approve a change to the terms and conditions of the lease that results in a change in the scope of or the consideration for the lease) if the modified contract is not accounted for as a separate contract. Refer to section 4.6, *Lease modifications*.

When remeasuring and reallocating the consideration in a contract, we believe a lessee should update the standalone prices upon any of the following:

* A lease modification that is not accounted for as a separate contract
* A change to the lease term
* A change in the assessment of whether a lessee is reasonably certain to exercise an option to purchase the underlying asset

We believe a lessee is not required to update to the standalone prices when there is (1) a change in the amount that it is probable the lessee will owe under a residual value guarantee or (2) a resolution of a contingency that results in some or all of the payments allocated to the lease component that were previously determined to be variable meeting the definition of lease payments, unless these events are combined with one of the other remeasurement and reallocation events listed above. Refer to section 3.5.1, *Summary of lease reassessment and remeasurement requirements.*

### Determining, allocating and reassessing the consideration in the contract —

lessors

Sales taxes and other similar taxes collected from lessees

ASC 842 allows lessors to make an accounting policy election not to evaluate whether sales taxes and other similar taxes imposed by a governmental authority on a specific lease revenue-producing transaction that are collected by the lessor from the lessee are the primary obligation of the lessor as owner of the underlying leased asset. A lessor that makes this election will exclude these taxes from the measurement of lease revenue and the associated expense. Taxes assessed on a lessor’s total gross receipts or on the lessor as owner of the underlying asset (e.g., property taxes) are excluded from the scope of the policy election. A lessor must apply the election to all taxes in the scope of the policy election and would provide certain disclosures. This policy election is similar to one that exists in the revenue standard for sales contracts that include sales taxes and other similar taxes collected from customers (refer to section 5.1, *Presentation of sales (and other similar) taxes*, in our FRD, [***Revenue from contracts with customers (ASC 606)***](https://www.ey.com/en_us/technical/accountinglink/financial-reporting-developments---revenue-from-contracts-with-c)).

A lessor that does not make the accounting policy election is required to analyze sales taxes and other similar taxes on a jurisdiction-by-jurisdiction basis to determine whether these taxes are the primary obligation of the lessor as owner of the underlying asset being leased or whether these taxes are costs of the lessee. If these taxes are a lessor cost, the lessor includes the amount in the measurement of lease revenue and the associated expense. If these taxes are a lessee cost, the lessor excludes these taxes from the measurement of lease revenue and the associated expense.

Certain lessor costs

Lessors are required to exclude lessor costs paid directly by lessees to third parties on the lessor’s behalf from variable payments and therefore variable lease revenue. ASC 842 also requires lessors to include lessor costs that are paid by the lessor and reimbursed by the lessee in the measurement of variable lease revenue and the associated expense.

Variable payments allocated to lease and non-lease components

Lessors are required to allocate (rather than recognize) certain variable payments to the lease and non-lease components when changes in facts and circumstances on which the variable payment is based occur. After the allocation, the amount of variable payments allocated to the lease component is recognized as income in profit or loss in accordance with ASC 842, and the amount allocated to the non-lease component is recognized in accordance with other guidance, such as ASC 606.

##### Determining the consideration in the contract — lessors

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

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* Any other variable payments that depend on an index or a rate made during the lease term and initially measured using the index or rate at the commencement date
* The payments described as lease payments in section 2.4, *Lease payments*
* Any other fixed payments (e.g., monthly service charges) or in-substance fixed payments made during the lease term, less any incentives paid or payable to the lessee

Consideration in the contract for a lessee

(ASC 842-10-15-35)

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

**=**

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

##### Allocating the consideration in the contract — lessors

Lessors are required to apply the guidance in ASC 606-10-32-28 through 32-41 to allocate the consideration in the contract to lease and separate non-lease components if they (1) do not make an accounting policy election (by class of underlying asset) to use the optional practical expedient to not separate lease and associated non-lease components or (2) make the accounting policy election but have at least one non-lease component that does not qualify for the expedient. Refer to section 1.4.2.4, *Practical expedient to not separate lease and non-lease components — lessors*. The guidance in this section and section 1.4.4.3, *Allocating variable payments — lessors*, assumes the entity has separate lease and non-lease components to which consideration must be allocated.

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

The standalone selling price is the price at which an entity would sell a promised good or service separately to a customer. The best evidence of standalone selling price is the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers.

When the standalone selling price is not directly observable, the lessor must estimate it. ASC 606-10-32-33 through 32-35 provides guidance for estimating the standalone selling price. Refer to section 6.1, *Determining standalone selling prices*, of our FRD, [***Revenue from contracts with customers (ASC 606)***](https://www.ey.com/en_us/technical/accountinglink/financial-reporting-developments---revenue-from-contracts-with-c), for a discussion of determining the standalone selling price and estimation methods.

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| **Illustration 1-12: Allocating the consideration in the contract (minimum purchase commitment of consumables)** |
| MedCo enters into a three-year contract with Hospital Co to lease equipment (e.g., an MRI machine) at no stated cost and to sell consumables that will be used specifically with the equipment for $3.50 per unit. Under the contract, Hospital Co has a minimum purchase commitment of 5,000 consumable products for each year of the three-year lease term. At lease commencement, Hospital Co estimates that the total purchases of consumable products during the lease term are equal to the minimum purchase commitment.  Under the terms of the contract, Hospital Co cannot use the equipment without the consumable products purchased exclusively from MedCo. Additionally, MedCo expects Hospital Co to purchase and use different amounts of consumable products each month.  At the lease commencement date, MedCo determines the following standalone selling prices for the lease and non-lease components in the contract based upon observable transactions in which Medco leases the equipment and sells consumable products separately in similar circumstances to similar customers:  $25,000 for the equipment for the three-year lease term and $2.50 per unit for the sale of consumables.  *Analysis:* MedCo determines that there is one lease component (for the medical equipment) and one non-lease component (sales of consumable products) in the agreement. The lessor practical expedient does not apply in this example because the timing and pattern of transfer of the lease and non-lease components are not the same.  At lease commencement, MedCo calculates the consideration in the contract to be $52,500 ($3.50 per unit x three-year lease term x 5,000 minimum required purchase of consumable units per year). MedCo applies the principles of ASC 606 to determine the standalone selling price of each component and the amount to allocate to each lease and non-lease component, as follows: |

|  |  |  |  |
| --- | --- | --- | --- |
| **Component** | **SSP** | **Relative percentage** | **Allocation of contract consideration** |
| **Equipment** | $ 25,000 | 40% | $ 21,000 |
| **Consumable products** | 37,500(a) | 60% | 31,500 |
| (a) $2.50/unit x 3 years x 5  Refer to Illustration estimated to be gre  Refer to our FRD*,* [***R***](https://www.ey.com/en_us/technical/accountinglink/financial-reporting-developments---revenue-from-contracts-with-c)  recognition and me | $ 62,500  ,000 units per year = $  1-13 for a scen ater than the mi  [***evenue from co***](https://www.ey.com/en_us/technical/accountinglink/financial-reporting-developments---revenue-from-contracts-with-c)  asurement of th | 100%  37,500  ario in which the tota nimum purchase com  [***ntracts with custome***](https://www.ey.com/en_us/technical/accountinglink/financial-reporting-developments---revenue-from-contracts-with-c)  e non-lease compone | $ 52,500  l purchases during the lease term are mitment.  [***rs (ASC 606)***](https://www.ey.com/en_us/technical/accountinglink/financial-reporting-developments---revenue-from-contracts-with-c)***,*** for additional details regarding nts. |
| **Illustration 1-13: Allocating the consideration in the contract (fixed payments and an option to purchase additional goods)** | | | |
| Lessee and Lessor enter into a two-year lease of medical equipment. Lessee agrees to pay a fixed payment of $50,000 per year. There are no variable lease payments that do not depend on an index or rate, and the lease would not result in selling losses if it was classified as a sales-type or direct financing lease. Legal title of the equipment passes to Lessee at the end of the lease term. Accordingly, Lessor classifies the lease as a sales-type lease. At lease commencement, the standalone price of a two- year lease of the equipment is $125,000.  Lessee also has the right, but not the obligation, to purchase disposables that are used with the medical equipment for $10 per disposable. At lease commencement, Lessor estimates that Lessee will purchase 20,000 disposables during the lease term. The price that Lessor charges Lessee for the disposables is consistent with the price that it charges other customers with a similar volume of purchases. Lessor concludes that the purchases of disposables are optional purchases and are not a form of variable consideration.  Lessor determines that the arrangement does not qualify for use of the lessor practical expedient in ASC 842-10-15-42A. That is, the lease of the medical equipment (i.e., the lease component) is not classified as an operating lease and the timing and pattern of transfer of the medical equipment and disposables (i.e., the non-lease components) are not the same (refer to section 1.4.2.4, *Practical expedient to not separate lease and non-lease components — lessors*). Therefore, under ASC 842, Lessor allocates the payments in the arrangement between the medical equipment and the disposables in a manner that is consistent with the transaction price allocation objective in ASC 606-10-32-28.  Lessor concludes that allocating the fixed payments of $100,000 ($50,000 per year x two years) entirely to the medical equipment would meet the allocation objective in ASC 606 because at lease commencement there are no existing non-lease components to which the fixed payments could be allocated. Lessor’s allocation methodology also would not result in an overallocation of the fixed payments to the lease component (i.e., $100,000 is less than the standalone price of $125,000) and, therefore, is not inconsistent with the allocation objective in ASC 606.  Lessor will then allocate payments, if any, for optional future purchases of disposables between the medical equipment and the disposables on a relative standalone price basis determined at lease commencement. This allocation methodology considers that the fixed payments were allocated entirely to the equipment. | | | |

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Component** | **SSP** | **Allocation of**  **estimated payments(a)** | **Allocation of fixed payment** | **Allocation of**  **payments for optional purchases** | **Allocation of payments for optional**  **purchases - %** |
| **Equipment** | $ 125,000 | $ 115,385(b) | $ 100,000 | $ 15,385 | 8% (d) |
| **Disposables** | 200,000 | 184,615(c) | – | 184,615 | 92% (e) |
|  | $ 325,000 | $ 300,000 | $ 100,000 | $ 200,000 | 100% |

|  |
| --- |
| Assume at lease commencement that Lessor determines that the standalone price of the disposables is $200,000 based on the estimated purchases of disposables during the lease term. Lessor allocates the fixed payments and the payments for the optional purchases as follows:   1. $100,000 of fixed payments + $200,000 of estimated payments for disposables ($10 per disposable X 20,000 estimated disposables to be purchased) 2. (125,000/325,000) x 300,000 3. (200,000/325,000) x 300,000 4. 15,385/200,000 5. 184,615/200,000   During the first year of the lease, Lessee purchases disposables totaling $100,000. Lessor allocates the payments to the lease and non-lease components as follows:  Lease component: (($100,000 fixed payments/two years) + ($100,000 x 8%)) = $58,000 Non-lease components (disposables): ($100,000 x 92%) = $92,000  **Note:** This allocation methodology would not be appropriate for Lessee. Further, while Lessor’s allocation methodology is consistent with the transaction price allocation objective in ASC 606, the use of other allocation methodologies may also be appropriate if those methodologies are consistent with the allocation objective in ASC 606. |

##### Allocating variable payments — lessors

If an arrangement includes variable payments, a lessor should carefully analyze the nature of the variable payments and the components to which they relate to determine how to allocate those amounts. Refer to Appendix F, *Variable payments – lessor*, for a flowchart illustrating how a lessor accounts for variable payments.

Variable payments included as consideration in the contract

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

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

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

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

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| **Illustration 1-14: Allocating the consideration in the contract: variable payments that specifically relate to the non-lease component** |
| Lessee and Lessor enter into a five-year lease of highly specialized equipment that includes specialized maintenance services on the equipment throughout the lease term. Lessee agrees to pay:   * A fixed payment of $200,000 per year; and * A variable payment each year that is based on the number of hours that the equipment is operating at specified performance metrics (i.e., the equipment is not malfunctioning or inoperable)   Assume Lessor properly concludes that the variable payments relate specifically to the outcome of its performance of the maintenance services (i.e., the non-lease component). Lessor evaluates the variable payments in accordance with the guidance on variable consideration in ASC 606 and estimates, using the expected value method, that it will be entitled to receive $50,000 in variable payments (subject to the constraint on variable consideration). Lessor measures the consideration in the contract at $1,050,000 ($200,000 x 5 years + $50,000 of estimated variable payments that specifically relate to the non-lease component). The standalone selling prices for the equipment and maintenance services are $1,350,000 and $200,000, respectively.  **Scenario 1**  Lessor concludes that allocating the variable payment of $50,000 entirely to the maintenance services would reasonably depict the amount of consideration to which it expects to be entitled in exchange for providing the equipment and maintenance services (i.e., this would result in an allocation that is consistent with the transaction price allocation objective in ASC 606-10-32-28). In this case, Lessor allocates the consideration in the contract as follows:  (a) (1,350,000/1,550,000) x 1,000,000  (b) (200,000/1,550,000) x 1,000,000  **Note**: If the consideration allocated to the maintenance services is significantly higher than the standalone selling price, this may indicate that the allocation is not consistent with the allocation objective in ASC 606-10-32-28 (i.e., allocating the variable payment entirely to the non-lease component may not depict the amount of consideration to which the lessor expects to be entitled in exchange for transferring the non-lease component). |

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| **Scenario 2**  Lessor concludes that allocating the variable payments entirely to the maintenance services would not result in an allocation that is consistent with the allocation objective in ASC 606-10-32-28. In this case, Lessor allocates the entire consideration in the contract of $1,050,000 between the equipment lease (i.e., lease component) and maintenance services (i.e., non-lease component) on a relative standalone selling price basis as follows:  (a) (1,350,000/1,550,000) x 1,000,000  (b) (200,000/1,550,000) x 1,000,000  (c) (1,350,000/1,550,000) x 50,000  (d) (200,000/1,550,000) x 50,000 |

Variable payments not included as consideration in the contract

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

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

If the terms of a variable payment amount other than those in ASC 842-10-15-35 (refer to section 1.4.3.1, *Determining the consideration in the contract — lessees*) relate to the lease component, even partially, lessors do not recognize those payments before the changes in facts and circumstances on which the variable payment is based occur (e.g., 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 payments are based occur, lessors allocate those payments to the lease and non-lease components. The allocation is on the same basis as the initial allocation of the consideration in the contract or on the same basis as the most recent reallocation if the contract was previously modified (ASC 842-10-15-40 and ASC 842-10-55-152) unless the variable payment meets the criteria in ASC 606-10-32-40 to be allocated only to the lease component(s).

After allocating, the amount of variable payments allocated to the lease component is recognized as income in profit or loss in accordance with ASC 842, and the amount allocated to the non-lease component is recognized in accordance with other guidance, such as ASC 606.

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| **Illustration 1-15: Allocating the consideration in the contract: variable payments that relate to the lease component even partially** |
| Entity A (lessee) and Entity B (lessor) enter into a three-year lease of retail space in a mall that includes common area maintenance throughout the lease term. Entity A agrees to pay a fixed payment of $100,000 per year and variable payments based on a percentage of sales. Entity B concludes that variable payments relate, at least partially, to the lease component and, therefore, Entity B measures the consideration in the contract at $300,000, which excludes the variable payments. Entity B allocates the consideration in the contract between the lease and maintenance services on the basis of relative standalone selling prices of each component, which, for purposes of this example, are $350,000 and $50,000.  Entity B subsequently allocates the income related to the variable payments between the lease and maintenance services on the same basis as the initial allocation of consideration in the contract or on the same basis as the most recent reallocation if the contract was previously modified. |

##### Initial direct costs or contract costs — lessors

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

A lessor allocates any capitalized costs (e.g., initial direct costs or contract costs capitalized in accordance with ASC 340-40, *Other Assets and Deferred Costs* — *Contracts with Customers)* to the separate lease components or non-lease components to which those costs relate, unless the lessor applies the practical expedient to not separate lease and non-lease components as discussed in section 1.4.2.4, *Practical expedient to not separate lease and non-lease components — lessors*.

##### Reassessment: determining and allocating the consideration in the contract — lessors

Lessors will remeasure and reallocate the remaining consideration in the contract upon a contract modification (i.e., a change to the terms and conditions of the contract that results in a change in the scope of or the consideration for the lease) that is not accounted for as a separate contract. Refer to section 5.6*, Lease modifications*. We believe a lessor should update the standalone selling prices used to reallocate the consideration in the contract when there is a contract modification that is not accounted for as a separate contract.

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

Refer to section 3.5.1, *Summary of lease reassessment and remeasurement requirements*. Refer to section 1.4.2.4, *Practical expedient to not separate lease and non-lease components — lessors*, for a discussion of the lessor practical expedient to combine lease and associated non-lease components.

## Contract combinations

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

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

The FASB indicated in the Basis for Conclusions (BC 165) of ASU 2016-02 that it developed these criteria to address concerns that separately accounting for multiple contracts may not result in a faithful representation of the combined transaction.

## Lease broker transactions

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

## Acquisition of lease residual values

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

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

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

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

## Service concession arrangements

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

(e.g., payments from the grantor, the right to charge third-party users of the assets). The operating entity may also construct the public-sector entity’s infrastructure or upgrade the existing infrastructure.

Although service concession arrangements historically have not been widely entered into either in the US or generally by US reporting entities, these arrangements are becoming more prevalent in certain industries, particularly in the energy and construction sectors (e.g., entities involved with assets such as power plants or bridges). However, all entities should evaluate each arrangement with a public-sector entity to determine whether the arrangement is in the scope of this guidance. Additionally, entities with equity method investees should also consider the accounting effects of their investees’ service concession arrangements, if any.

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

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

Public service

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

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

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

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

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

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

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

Control of the residual interest

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

Accounting for a service concession arrangement

For service concession arrangements that are in the scope of ASC 853, the operating entity should not account for the arrangement as a lease (i.e., in accordance with ASC 842) and should not recognize the infrastructure as property, plant and equipment (i.e., in accordance with ASC 360). Instead, the operating entity in the scope of ASC 853 should account for revenue from service concession arrangements in accordance with ASC 606. The accounting under ASC 606 may be similar to other non-lease service and management contracts where a party manages property or equipment on behalf of the owner.

The operating entity should refer to other US GAAP to account for the various other aspects of a service concession arrangement. The FASB did not specify which other aspects of US GAAP should be applied to service concession arrangements within the scope of ASC 853, except to say that service concession arrangements in the scope of both ASC 853 and ASC 980, *Regulated Operations*, should be accounted for using ASC 980 instead of ASC 853. Refer to section 1.8.1, *Service concession arrangements in regulated operations*, for additional information about service concession arrangements that may also be within the scope of ASC 980.

Arrangements not in the scope of ASC 853 should first be evaluated by the operating entity using the criteria in ASC 842 to determine whether lease accounting is appropriate.

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

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| **Illustration 1-16: Accounting for a service concession arrangement** |
| Company Q (Company Q or operating entity) enters into an arrangement with the State X Department of  Transportation (referred to as the DOT), State X’s governmental entity responsible for its public highways.  Under the terms of the arrangement, Company Q will be required to perform the following services: construct, operate and maintain the DOT’s toll highway for a period of 20 years. The arrangement does not contain any renewal periods.  The DOT will control any residual interest in the highway at the end of the 20-year contractual period.  The arrangement requires Company Q to operate the toll highway by allowing the public to access and travel upon the constructed highway (i.e., a public service) in exchange for a toll that will be collected from each vehicle. The arrangement does not provide Company Q with any rights to unilaterally change the services that it must provide with the highway (e.g., roadway maintenance, emergency access and services, rest area concessions) or to whom it must provide the services.  The arrangement initially sets the toll within a specified range, determined by the DOT, of $0.50 to  $1.00 per vehicle. Future changes to the toll amount (i.e., price changes outside the specified range)  require the DOT’s approval.  *Analysis*: The arrangement is a service concession arrangement. The arrangement involves an operating entity (Company Q) contracting with a public-sector entity grantor (the DOT) to provide a public service, and the following two conditions are met:   1. The DOT controls or has the ability to modify or approve the services that the operating entity must provide with the toll highway, to whom it must provide them and at what price. 2. The DOT controls, through ownership, beneficial entitlement or otherwise, any residual interest in the toll highway at the end of the term of the arrangement. |

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

### Service concession arrangements in regulated operations

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

# Key concepts

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

## Inception of a contract

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

## Commencement date of the lease

The commencement date is the date on which the lessor makes an underlying asset (i.e., the property, plant or equipment that is subject to the lease) available for use by the lessee. In some cases, the commencement date of the lease may be before the date stipulated in the lease agreement (e.g., the date rent becomes due and payable). This often occurs when the underlying asset is modified by the lessee prior to commencing operations with the underlying asset (e.g., during the period a lessee uses leased space to construct its own leasehold improvements). In making the assessment of lease commencement, it will often be necessary to distinguish between lessee and lessor assets (refer to section 2.11, *Improvements to the underlying asset*).

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

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| **Illustration 2-1: Determining the lease commencement date** |
| **Scenario A**  Assume that Entity A (the lessee) leases existing office space from Entity B (the lessor), and both parties execute the lease on 1 December 20X6. Entity B provides Entity A with access to the space on 1 February 20X7 so that Entity A can begin to construct its own leasehold improvements (i.e., the improvements are lessee assets). On 1 June 20X7, following substantial completion of construction of the leasehold improvements, the office space is in a condition for Entity A to begin using it for its operations and makes its first rental payment to Entity B.  *Analysis:* The lease commencement date is 1 February 20X7, the date on which Entity B made the underlying asset available for use by Entity A. On the commencement date (i.e., 1 February 20X7), the lessee would generally recognize a right-of-use asset and a lease liability (refer to section 4, *Lessee accounting*) and the lessor (for direct financing and most sales-type leases) recognizes its net investment in the lease. Additionally, the lease commencement date would be 1 February 20X7 regardless of who is constructing the lessee owned leasehold improvements (i.e., the lessee, the lessor or a third party) and whether the lessor is finishing minor construction activities on the underlying asset after the lessee is granted access.  **Scenario B**  Assume the same facts as in Scenario A, except that the improvements being constructed by Entity A are lessor assets (i.e., they are not leasehold improvements of Entity A).  *Analysis*: The lease commencement date is 1 June 20X7, the date on which Entity B made the underlying asset available for use by Entity A. On the commencement date (i.e., 1 June 20X7), the lessee would generally recognize a right-of-use asset and a lease liability (refer to section 4, *Lessee accounting*) and the lessor (for direct financing and most sales-type leases) recognizes its net investment in the lease. |

### Lease commencement date for master lease agreements

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

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

## Lease term and purchase options

### Lease term

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

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

**Lease term**

* 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 (that is, the lease term includes the period after the date of the termination option if the lessee is reasonably certain it will not exercise the option to terminate the lease)
* Periods covered by an option to extend (or not terminate) the lease in which the exercise of the option is controlled by the lessor

The FASB indicated in the Basis for Conclusions (BC 195) of ASU 2016-02 that the phrase “reasonably certain” is generally interpreted as a high threshold. Refer to section 2.3.5, *Evaluating lease term and purchase options*, for further discussion on evaluating whether a lessee is reasonably certain to exercise an option to renew the lease, not terminate the lease or purchase the underlying asset.

##### Nonconsecutive periods of time

Lessees may enter into lease contracts for nonconsecutive periods of time. These arrangements meet the definition of a lease if the customer controls the right to use an identified asset throughout the agreed period of use in exchange for consideration. In these cases, the lease term is the sum of the nonconsecutive periods of time. For example, a retailer may enter into a noncancelable lease to use the same retail space for the months of October, November and December of each year for a period of five years. In this example, the lease term at the commencement date of the lease is 15 months (three months per year for the five annual periods specified in the contract).

### Purchase options

Purchase options should be assessed in the same way as options to extend the lease term or terminate the lease. The FASB indicated in the Basis for Conclusions (BC 218) of ASU 2016-02 that an option to purchase an underlying asset is economically similar to an option to extend the lease term for the remaining economic life of the underlying asset. When a lease contains a purchase option and the lessee is reasonably certain to exercise that option, the lease is classified as a finance lease by a lessee and a sales- type lease by a lessor. Refer to section 3.1*, Criteria for lease classification — lessees,* or section 3.2, *Criteria for lease classification* — *lessors*.

### Cancelable leases

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

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

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| **Illustration 2-2: Cancelable leases** |
| **Scenario A**  A lease has an initial noncancelable period of one year and will be extended for an additional year under terms specified in the contract if both the lessee and the lessor agree. There is no penalty1 if the lessee and the lessor do not agree to extend the term.  *Analysis:* The initial one-year noncancelable period meets the definition of a contract because it creates enforceable rights and obligations. However, the one-year extension period does not meet the definition of a contract because both the lessee and the lessor could unilaterally elect not to extend the arrangement without a more than insignificant penalty. 1  **Scenario B**  A lease has an initial period of five years but can be terminated at the end of the third year at the  option of the lessor. The lessee’s consent is not required for the termination option to be exercised.  *Analysis*: The lease term consists of the initial five-year period because it creates enforceable rights and obligations that can only be terminated by the lessor.  **Scenario C**  A lease has an initial noncancelable period of two years. Neither the lessee nor the lessor can cancel the contract before the end of the second year. At the end of the second year, the contract automatically extends on a month-to-month basis for up to three years, unless either the lessor or the lessee exercises its unilateral right to terminate the contract. That is, after the second year, both the lessee and lessor have a right to terminate the lease without permission from the other party. |

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| Further, assume the following as of the lease commencement date:   * The terms and conditions for the lease (e.g., lease payments) for the monthly periods in years three through five are included in the contract. * The lessor would not suffer a more than insignificant penalty1 if it terminated the contract at any time after the initial two years. * Due to the unique purpose and location of the underlying asset and the significance of the lessee’s leasehold improvements, the lessee would suffer a more than insignificant penalty1 if it were to exercise its termination rights before the end of the third year. The lessee also concludes it is reasonably certain not to terminate the lease before the end of the third year.   *Analysis:* The initial two-year noncancelable period meets the definition of a contract. The first 12 monthly periods in year three are also included in the contract’s enforceable period because the lessee would suffer a more than insignificant penalty1 if it were to terminate the lease before the end of the third year. Additionally, because both the lessee and the lessor have the right to terminate the contract without permission from the other party without a more than an insignificant penalty after the third year, the agreement does not create enforceable rights and obligations beyond the three-year period and therefore would no longer meet the definition of a contract. Consistent with ASC 842-10-55-24, the likelihood of the lessor exercising the termination option during year three is not considered in the evaluation of the lease term.  In this scenario, the lease term is three years because the lessee concludes it is reasonably certain not to terminate the lease during the third year.  The evaluation of whether a lessee is reasonably certain not to terminate a contract considers all facts and circumstances, including any more than insignificant penalty the lessee would incur at each termination date. The more significant the penalty the lessee would incur, the greater the likelihood that the lessee would be reasonably certain not to terminate the contract.  1 Refer to section 2.3.4, *Penalty*, for a discussion of the definition of a penalty. |

### Penalty

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

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

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

### Evaluating lease term and purchase options

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

* The pricing of a purchase option or lease renewal option (e.g., fixed rates, discounted rates,

“bargain” rates)

* The amount of payments for termination or nonrenewal and the pricing of the continuing lease
* Contingent amounts due under residual value guarantees and other variable lease payments
* Costs of returning the asset in a contractually specified condition or to a contractually specified location
* Significant customization (e.g., leasehold improvements), installation costs or relocation costs
* The importance of the underlying asset to the lessee’s operations, considering the potential business

disruptions from not having the underlying asset and the availability of a replacement asset

* A sublease term that extends beyond the noncancelable period of the head lease (e.g., a head lease that has a noncancelable term of five years with a two-year renewal option, and the sublease term is for seven years)
* A guarantee by the lessee of the lessor’s debt directly or indirectly related to the underlying asset

The term “reasonably certain” is generally considered to be a high threshold (refer to section 2.3.1,

*Lease term*).

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

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

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

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

Consistent with paragraph B40 of IFRS 16, we believe that a lessee’s past practice regarding the period over which it typically has used particular types of assets (whether leased or owned), and its economic incentives for doing so, may provide information that is helpful in assessing whether the lessee is reasonably certain to exercise, or not to exercise, an option. For example, if a lessee has typically used particular types of assets for a particular period of time or if the lessee has a practice of frequently exercising options on leases of particular types of underlying assets, we believe the lessee should consider the economic incentives for that past practice in assessing whether it is reasonably certain to exercise an option on leases of those assets.

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| **Illustration 2-3: Determining the lease term** |
| **Scenario A**  Assume that Entity P enters into a lease for equipment that includes a noncancelable term of four years and a two-year fixed-price renewal option with future lease payments that are intended to approximate market rates at lease inception. There are no termination penalties or other factors indicating that Entity P is reasonably certain to exercise the renewal option.  *Analysis:* At the lease commencement date, the lease term is four years.  **Scenario B**  Assume that Entity Q enters into a lease for a building that includes a noncancelable term of four years and a two-year, fixed-price renewal option with future lease payments that are intended to approximate market rates at lease inception. Before it takes possession of the building, Entity Q pays for leasehold improvements. The leasehold improvements are expected to have significant value at the end of four years, and that value can only be realized through continued occupancy of the underlying asset.  *Analysis:* At lease commencement, Entity Q determines that it is reasonably certain to exercise the renewal option because it would suffer a significant economic penalty if it abandoned the leasehold improvements at the end of the initial noncancelable period. At lease commencement, Entity Q concludes that the lease term is six years. |

##### Renewal penalty

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

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

##### The effect of a sublease on the lease term

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

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

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| **Illustration 2-4: Evaluating a lessee's head lease term when a sublease exists** |
| Assume Entity A leases land (the head lease) for an initial five-year term followed by four successive five-year renewal options. Entity A immediately constructs a radio tower on the land and enters into a lease (as sublessor) with Radio Station B for an initial term of 10 years followed by three successive five-year renewals at Radio Station B’s option. Entity A concludes Radio Station B is reasonably certain to exercise the first of its five-year renewal options based on consideration of all contract, asset and market-based factors, resulting in a total lease term on the sublease of 15 years.  *Analysis:* The lease term used by Entity A in its accounting for the head lease would be at least 15 years (i.e., the noncancelable term of the sublease plus the five-year renewal period that Entity A has concluded Radio Station B is reasonably certain to exercise). If Radio Station B exercises its extension options beyond the 15-year lease term, Entity A would reassess the lease term on the head lease consistent with the guidance in ASC 842-10-55-28. |

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

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

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| **Illustration 2-5: Guarantee of residual value upon early termination** |
| Assume a lessee guarantees to a lessor that if the lessee terminates a five-year lease at the end of three years, the residual value of the underlying asset at the end of three years will not be less than $3,000.  *Analysis:* The lessee and lessor would evaluate the $3,000 residual value guarantee, in light of other factors, to determine whether it serves as a penalty such that the lessee is reasonably certain to not exercise its termination option due to the existence of the guarantee. If the lessee is reasonably certain to not exercise its termination option, the lease term would be five years. |

Refer to section 2.4.6, *Amounts it is probable that a lessee will owe under residual value guarantees —*

*lessees only*, for further discussion of evaluating residual value guarantees.

##### Fiscal funding clause

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

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

### Reassessment of the lease term and purchase options

##### Reassessment of the lease term and purchase options — lessees (updated July 2024)

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

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

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

* Constructing significant leasehold improvements that are expected to have significant economic value for the lessee when the option becomes exercisable
* Making significant modifications or customizations to the underlying asset
* Making a business decision that is directly relevant to the lessee’s ability to exercise or not exercise

an option (e.g., extending the lease of a complementary asset or disposing of an alternative asset)

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

Changes in market-based factors (e.g., a change in market rates to lease or purchase a comparable asset) are not within the lessee’s control, and they therefore do not trigger a reassessment by themselves. Further, events or changes in circumstances that indicate the carrying amount of an ROU asset may not be recoverable in accordance with ASC 360-10 that do not occur or arise as a result of an action that is within the control of the lessee do not, in isolation, trigger a reassessment of the lease term or a lessee option to purchase the underlying asset. Refer to section 4.2.5, *Impairment of right-of-use assets in operating leases,* and section 4.3.4*, Impairment of right-of-use assets in finance leases*.

The following examples illustrate changes in market-based factors that are not in the lessee’s control and, therefore, would not, by themselves, trigger a reassessment.

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| **Illustration 2-6: Changes in market-based factors that are indicators of impairment in accordance with ASC 360-10** |
| Lessee experiences a decline in sales and negative cash flows at one of its leased stores due to the effects of inflation and rising interest rates. Lessee identified these factors as indicators of impairment under ASC 360-10 and tested the related asset group for recoverability under ASC 360-10.  **Analysis**  The decline in sales and negative cash flows are market-based factors that are not within the lessee’s control. While these indicators might trigger the requirement for Lessee to perform the recoverability test in accordance with ASC 360-10, an impairment evaluation and any related impairment loss recognized would not, by themselves, trigger a reassessment of the lease term in accordance with ASC 842-10-35-1(a). |

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| **Illustration 2-7: Changes in market-based factors that change a lessee’s assessment of**  **whether it is reasonably certain to terminate a lease early** |
| Lessee enters into a 10-year lease of a retail store with an option to terminate the lease after seven years. At lease commencement, Lessee is reasonably certain that it will not terminate the lease after seven years and concludes that the lease term is 10 years.  After experiencing declining market conditions during the first five years of the lease, Lessee believes that it is no longer reasonably certain it will not terminate the lease after seven years. However, Lessee decides to wait until it is contractually required to notify the landlord about whether it is electing to terminate the lease.  **Analysis**  Although Lessee now believes it is no longer reasonably certain to not terminate the lease after seven years, Lessee would not reassess the lease term. That is, until there are significant events or significant changes in circumstances within Lessee’s control that directly affect whether it is reasonably certain to not terminate the lease early (e.g., communicating to employees they will be terminated, altering significant supply contracts, announcing that the store will permanently close), then there is no reassessment event in accordance with ASC 842. |

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

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

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

Question 2-1 How should airlines assess the lease term of terminal leases that cover periods as short as 30 days and do not have contractual renewal options but for which the airline’s right to renew the same or substantially similar space is guaranteed under US law? (added July 2024)

An airline’s legal right to renew a terminal lease should be considered when determining the lease term. An airline will need to assess, for each lease, whether it is reasonably certain to exercise its right to renew and, if so, for what period.

Determining whether the reasonably certain threshold has been met requires significant judgment. An airline might consider the following factors in its assessment:

* How significant the airport is to the airline’s operations (e.g., a hub airport)
* Whether the airline has made significant leasehold improvements at the airport
* Whether the airline has guaranteed the airport’s debt
* Whether the airline has other significant long-term assets related to the terminal lease (e.g., intangible assets related to rights to fly between two countries or to take off or land at an airport)

##### Reassessment of the lease term and purchase options — lessors

A lessor does not reassess the lease term or a lessee’s option to purchase the underlying asset unless the lease is modified (i.e., the terms and conditions of the contract are changed in a way that results in a change in the scope of the lease or the consideration) and the modified lease is not accounted for as a separate contract. Additionally, ASC 842-10-35-3 requires a lessor to account for a lessee’s exercise of an option to extend or terminate the lease or purchase the underlying asset in the same manner as a lease modification when the exercise is inconsistent with the lessor’s previous assumption about whether the lessee would exercise the option. Refer to section 5.6, *Lease modifications*. For example, if a lessor excluded an optional period to extend the lease from the lease term because it concluded that the lessee was not reasonably certain to exercise that option, the exercise of the option by the lessee should be accounted for as a lease modification.

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

## Lease payments

Lease payments are payments, made by a lessee to a lessor (or a third party on behalf of the lessor), relating to the right to use an underlying asset during the lease term and include the following amounts:

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| **Lease payments7, 8** | | | | | |
| Fixed (including  in-substance fixed) payments, less any lease incentives paid or payable to the lessee1 | Variable payments based on an index or rate2 | Exercise price of a purchase option3 | Payments for penalties for terminating the lease4 | Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction5 | Amounts it is probable that the lessee will owe under residual value guarantees (lessees only)6 |
|  | | | | | |
| 1 Refer to section 2.4.1, *Fixed (including in-substance fixed) lease payments and lease incentives.*  2 Refer to section 2.4.2, *Variable lease payments that depend on an index or rate.*  3 Refer to section 2.4.3, *The exercise price of a purchase option*. Include only if reasonably certain of exercise.  4 Refer to section 2.4.4, *Payments for penalties for terminating a lease*. Include only if the lease term reflects the lessee exercising an option to terminate the lease.  5 Refer to section 2.4.5, *Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction.*  6 Refer to section 2.4.6, *Amounts it is probable that a lessee will owe under residual value guarantees — lessees only.*  7 Refer to section 2.4.7, *Payments made by a lessee prior to the beginning of the lease term.*  8 In some cases, a lessee may incur costs or make payments (e.g., to the lessor or a third party) for lessor assets  (e.g., improvements to the underlying asset). These payments are treated in the same manner as making a cash payment to the lessor and are accounted for as either fixed or variable payments. Determining whether the payments are fixed or variable depends on the terms and conditions of the contract. Refer to section 2.4.1, *Fixed (including in-substance fixed) lease payments and lease incentives,* and section 2.4.2, *Variable lease payments that depend on an index or rate.* | | | | | |

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

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

ASC 842-10-30-6 does explicitly note that lessee’s guarantees of lessor’s debt are excluded from lease

payments (refer to section 2.4.10, *Amounts not included in lease payments*).

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

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

##### In-substance fixed lease payments (updated July 2024)

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

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

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

Subsequent changes in the fair value of the derivative would be recognized in income at each reporting period.

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

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| **Illustration 2-8: In-substance fixed lease payments** |
| Company A leases a building for five years with a fair value of $100 from Lessor B. The lease agreement provides that the lease payments start at $10 annually. The annual adjustment is based on three times the annual increase in the CPI, but the aggregate annual adjustment is limited to 3%.  *Analysis:* Company A concludes that in substance, it has agreed, at the commencement date of the lease, to pay Lessor B additional lease payments in the amount of 3% per year. As a result, the 3% increase represents an in-substance fixed lease payment that would be included in the measurement of the right-of-use asset.  The following would be the straight-line rent calculation for both the lessee and lessor:  1 If the multiplier of the CPI were considered a derivative instead of an in-substance lease payment (at the capped amount), the day-one fair value of the derivative would be included as a lease payment for purposes of determining straight-line rent (as well as assessing lease classification). Subsequent changes in the fair value of the derivative would be recognized in income at each reporting period. |

Question 2-2 Contracts to use drilling rigs, often pricing terms that may appear to be fully variable. In such contracts and for purposes of measuring the lease liability and right-of-use asset, how does the lessee determine whether payments are in-substance fixed payments or variable payments? (added July 2024)

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| --- | --- | --- |
| **Year** | **Lease payments** | **Straight-line rental revenue/expense1** |
| 1 | $10.00 | $ 10.62 |
| 2 | $10.30 ($10.00 x 1.03) | $ 10.62 |
| 3 | $10.61 ($10.30 x 1.03) | $ 10.62 |
| 4 | $10.93 ($10.61 x 1.03) | $ 10.62 |
| 5 | $11.26 ($10.93 x 1.03) | $ 10.62 |

Consideration paid for the use of drilling rigs is typically expressed as a rate paid for each operating day, hour or fraction of an hour. Examples of the types of rates a lessee may be charged include:

* Full operating rate — a periodic rate charged when the rig is operating at full capacity with a full crew
* Standby rate or cold-stack rate — a periodic rate charged when the lessee unilaterally puts the rig on standby
* Major maintenance rate — a minimal periodic rate, which may in some cases be a “zero rate,” charged when the lessor determines that maintenance needs to be performed and the rig is not available for use by the lessee
* Inclement weather rate — a minimal periodic rate, which may in some cases be a “zero rate,” charged when weather makes it dangerous to operate the rig and, therefore, to protect the lessor’s asset, the underlying drilling rig is not available for use by the lessee

We believe, informed by discussions with the FASB staff, that there typically is a minimum rate in drilling contracts (i.e., fixed lease payments). When present, this amount is commonly the lowest rate that the lessee would pay while the asset is available for use by the lessee. Depending on the contract, this rate may be referred to using terms such as a standby or cold-stack rate. When identifying the lease payment (i.e., the in-substance fixed payment) in a drilling contract, an entity should only consider rates that apply when the asset is available for use by the lessee. Additional rates incurred would be considered variable lease payments. Further, rates that apply only when the asset is unavailable for use by the lessee (e.g., an inclement weather rate) are excluded for purposes of measuring the lease liability.

##### Lease incentives (updated August 2023)

A lease agreement with a lessor might include incentives for the lessee to sign the lease, such as an up- front cash payment to the lessee, payment of costs for the lessee (such as moving expenses) or the assumption by the lessor of the lessee’s preexisting lease with a third party. Refer to section 4.7, *Lease incentives and improvements*, for further discussion of lease incentives.

Lessee

For lessees, lease incentives that are paid or payable to the lessee at lease commencement (or on the effective date of a lease modification) are deducted from lease payments, which affects the lease classification test and reduces the initial measurement of a lessee’s right-of-use asset. Lease incentives that are payable to the lessee at lease commencement (or on the effective date of a lease modification) also reduce a lessee’s lease liability.

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| **Illustration 2-9: Lessee accounting for lease incentives paid or payable at commencement** |
| On 1 January 20X1 (the commencement date of the lease), a lessee (Retailer) leases retail space in a shopping center for 10 years. Retailer agrees to pay a fixed payment per year of $100,000, due on 31 December of each year. The present value of the lease payments is $772,000 using a discount rate of 5%. Retailer incurs no initial direct costs. The lease is classified as an operating lease.  **Scenario A**  To incentivize Retailer to enter into the lease, the lessor pays Retailer $100,000 on the commencement date of the lease.  *Analysis:* Retailer records the right-of-use asset, lease liability and lease incentive on the commencement date as follows:  Right-of-use asset $ 672,000  Cash 100,000  Lease liability $ 772,000  The following journal entries would be recorded in Year 1:  Lease expense $ 100,000  Cash $ 100,000  *To record lease expense and cash paid.* |

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| Right-of-use asset (amortization of lease incentive) $ 10,000  Lease expense (amortization of lease incentive) $ 10,000  *To record amortization of the lease incentive ($100,000 ÷ 10 years = $10,000).*  Lease liability $ 61,000  Right-of-use asset $ 61,000  *To adjust the lease liability to the present value of the remaining lease payments with an offset to the right-of-use asset. The adjustment of $61,000 is calculated as the initially recognized lease liability ($772,000) less the present value of the remaining lease payments ($711,000) at the end of Year 1.*  **Scenario B**  Assume the same facts as Scenario A. However, to incentivize Retailer to enter into the lease, the lessor agrees to pay Retailer $100,000 at the end of the first year of the lease (i.e., 31 December 20X1). There is no contingency associated with Retailer’s right to receive the payment.  *Analysis:* In this scenario, the lease incentive receivable reduces Retailer’s lease payments by the  $100,000 when initially measuring the right-of-use asset and lease liability at lease commencement:  Right-of-use asset $ 677,000  Lease liability $ 677,000  *To record the right-of-use asset and lease liability at commencement. The lease liability of $677,000 is calculated as the 10 $100,000 payments less the $100,000 receivable from the lessor due in one year, discounted at 5%.*  The following journal entries would be recorded in Year 1:  Lease expense $ 100,000  Cash $ 100,000  *To record lease expense and cash paid.*  Cash $ 100,000  Lease liability $ 100,000  *To record the cash incentive received.* |
| Right-of-use asset (amortization of lease incentive) $ 10,000  Lease expense (amortization of lease incentive) $ 10,000  *To record amortization of the lease incentive ($100,000 ÷ 10 years = $10,000).*  Lease liability $ 66,000  Right-of-use asset $ 66,000  *To adjust the lease liability to the present value of the remaining lease payments with an offset to the right-of-use asset. The adjustment of $66,000 is calculated as the initially recognized lease liability ($677,000) plus the adjustment to the lease liability resulting from the cash receipt of the lease incentive ($100,000) less the present value of the remaining lease payments ($711,000) at the end of Year 1.* |

ASC 842 does not provide guidance on how to recognize lease incentives that are neither paid nor payable at lease commencement or on the effective date of a lease modification. A lease incentive is neither paid nor payable at lease commencement or on the effective date of a lease modification if the timing and amount of payment from the landlord depend on future events (e.g., the timing and amount of the qualified costs a retailer incurs to construct leasehold improvements). We believe the following approaches would be acceptable:

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

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| **Illustration 2-10: Lessee accounting for lease incentives not paid or payable at commencement using Approach 1** |
| On 1 January 20X1 (the commencement date of the lease), Lessee leases retail space in a shopping center from Lessor for 10 years. Lessee agrees to pay a fixed payment per year of $850,000, due on 31 December of each year. The present value of the lease payments is $6,563,000 using a discount rate of 5%. Lessee incurs no initial direct costs. The lease is classified as an operating lease.  Lessor provides an incentive allowance to reimburse Lessee for the cost of leasehold improvements up to $100,000. Lessee is required to provide proof of payment of qualified expenditures to receive the incentive from Lessor. Lessor will pay the incentive at the end of the year in which the Lessee submits proof of payment (i.e., this may not be the year in which the costs are incurred).  Assume the following at lease commencement:   * Lessee has incurred $10,000 of reimbursable costs associated with design of the leasehold improvements and has submitted a request for payment to Lessor (i.e., the incentive will be paid at the end of year 1). * Lessee has contracted for and is reasonably certain it will incur costs in excess of the maximum allowance of $100,000 to construct the remaining leasehold improvements by the end of the first year of the lease term.   Assume the following at the end of year 1:   * Lessee receives the cash incentive of $10,000 for reimbursable costs incurred prior to lease commencement and submitted to Lessor at lease commencement. * Lessee incurs the remaining reimbursable costs of $90,000 at a single point in time (at the end of the first year of the lease term) and plans to submit the request for payment to Lessor in year 2. |

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| Assume the following at the end of year 2:   * Lessee receives the cash incentive of $90,000 for reimbursable costs incurred in year 1 that the Lessee submitted to Lessor in year 2.   **Journal entries**  The full lease incentive of $100,000 is deemed payable by the lessor at the commencement date because the lease specifies a maximum level of reimbursement and the lessee is reasonably certain to incur costs equal to or exceeding this level. For simplicity, amounts separately capitalized by the lessee as leasehold improvements (in accordance with ASC 360-10) are not included in this illustration.  At lease commencement, the lease incentive reduces Lessee’s lease payments by the full amount of the lease incentive when initially measuring the right-of-use asset and lease liability:  Right-of-use asset $ 6,472,000  Lease liability $ 6,472,000  *To record the right-of-use asset and lease liability at lease commencement. The ROU asset and lease liability of $6,472,000 are calculated as the present value of (1) the 10 annual $850,000 payments less (2) the $10,000 lease incentive receivable from Lessor at the end of year 1 and less (3) the*  *$90,000 lease incentive expected to be received from Lessor at the end of year 2.*  The following journal entries would be recorded in year 1:  Lease expense $ 850,000  Cash $ 850,000  *To record lease expense and cash paid.*  Cash $ 10,000  Lease liability $ 10,000  *To record the cash incentive of $10,000 received for reimbursable costs submitted to Lessor at lease commencement.*  Right-of-use asset (amortization of lease incentive) $ 10,000  Lease expense (amortization of lease incentive) $ 10,000  *To record amortization of the lease incentive ($100,000 ÷ 10 years = $10,000).*  Lease liability $ 526,000  Right-of-use asset $ 526,000  *To adjust the lease liability to the present value of the remaining lease payments with an offset to the right-of-use asset. The adjustment of $526,000 is calculated as the accretion of the lease liability ($6,472,000 x 5% = $324,000) less the annual cash lease payment ($850,000).*  The following journal entries would be recorded in year 2:  Lease expense $ 850,000  Cash $ 850,000  *To record lease expense and cash paid.*  Cash $ 90,000  Lease liability $ 90,000  *To record the cash incentive of $90,000 received for reimbursable costs submitted to Lessor at the end of year 1.* |

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| Right-of-use asset (amortization of lease incentive) $ 10,000  Lease expense (amortization of lease incentive) $ 10,000  *To record amortization of the lease incentive ($100,000 ÷ 10 years = $10,000).*  Lease liability $ 552,000  Right-of-use asset $ 552,000  *To adjust the lease liability to the present value of the remaining lease payments with an offset to the right-of-use asset. The adjustment of $552,000 is calculated as the accretion of the lease liability ($5,956,000 x 5% = $298,000) less the annual cash lease payment ($850,000).*  The following journal entries would be recorded in year 3:  Lease expense $ 850,000  Cash $ 850,000  *To record lease expense and cash paid.*  Right-of-use asset (amortization of lease incentive) $ 10,000  Lease expense (amortization of lease incentive) $ 10,000  *To record amortization of the lease incentive ($100,000 ÷ 10 years = $10,000).*  Lease liability $ 575,000  Right-of-use asset $ 575,000  *To adjust the lease liability to the present value of the remaining lease payments with an offset to the right-of-use asset. The adjustment of $575,000 is calculated as the accretion of the lease liability ($5,494,000 x 5% = $275,000) less the annual cash lease payment ($850,000).*  Lessee would record similar entries in years 4 through 10.  Refer to Illustration 2-12 for a summary of the lease expense, ROU asset and lease liability amounts at lease commencement, the end of year 1, the end of year 2 and the end of year 3 under Approach 1 as well as a comparison to Approaches 2 and 3. |

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| **Illustration 2-11: Lessee accounting for lease incentives not paid or payable at commencement using Approaches 2 and 3** |
| Assume the same facts as in Illustration 2-10 above. For simplicity, amounts capitalized by the lessee as leasehold improvements (in accordance with ASC 360-10) are not included in this illustration.  **Journal entries under Approach 2**  The lease incentive does not reduce the right-of-use asset or lease liability until Lessee has incurred costs and the amounts qualify for reimbursement by Lessor. In this example, only the $10,000 in costs incurred by the lessee that are receivable by the lessee reduce the right-of-use asset and lease liability at the lease commencement date.  The following journal entry is recorded when Lessee measures its right-of-use asset and lease liability at lease commencement.  Right-of-use asset $ 6,554,000  Lease liability $ 6,554,000  *To record the right-of-use asset and lease liability at lease commencement. The ROU asset and lease liability of $6,554,000 are calculated as the present value of (1) the 10 annual $850,000 payments less (2) the $10,000 lease incentive receivable from Lessor at the end of year 1.* |

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| The following journal entries would be recorded in year 1:  Lease expense $ 850,000  Cash $ 850,000  *To record lease expense and cash paid.*  Cash $ 10,000  Lease liability $ 10,000  *To record the cash incentive of $10,000 received at the end of year 1 for reimbursable costs submitted to Lessor at lease commencement.*  Right-of-use asset (amortization of lease incentive) $ 1,000  Lease expense (amortization of lease incentive) $ 1,000  *To record amortization of the lease incentive ($10,000 ÷ 10 years = $1,000).*  Lease liability $ 86,000  Right-of-use asset $ 86,000  *To reduce the lease liability when Lessee incurs the remaining reimbursable costs at the end of year 1 for the present value of the $90,000 lease incentive receivable from Lessor at the end of year 2.*  Lease liability $ 522,000  Right-of-use asset $ 522,000  *To adjust the lease liability to the present value of the remaining lease payments with an offset to the right-of-use asset. The adjustment of $522,000 is calculated as the accretion of the lease liability ($6,554,000 x 5% = $328,000) less the annual cash lease payment ($850,000).*  The following journal entries would be recorded in year 2:  Lease expense $ 850,000  Cash $ 850,000  *To record lease expense and cash paid.*  Cash $ 90,000  Lease liability $ 90,000  *To record the cash incentive of $90,000 received in year 2 for reimbursable costs submitted to Lessor at the end of year 1.*  Right-of-use asset (amortization of lease incentive) $ 11,000  Lease expense (amortization of lease incentive) $ 11,000  *To record amortization of the lease incentive. The remaining lease incentive of $99,000 ($90,000 plus*  *$9,000 unamortized from year 1) is amortized over the remaining lease term ($99,000 ÷ 9 years =*  *$11,000).*  Lease liability $ 552,000  Right-of-use asset $ 552,000  *To adjust the lease liability to the present value of the remaining lease payments with an offset to the right-of-use asset. The adjustment of $552,000 is calculated as the accretion of the lease liability ($5,956,000 x 5% = $298,000) less the annual cash lease payment ($850,000).* |

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| The following journal entries would be recorded in year 3:  The journal entries under Approach 2 would be the same as under Approach 1 for year 3, except for the incentive amortization, which would be recorded as follows under Approach 2:  Right-of-use asset (amortization of lease incentive) $ 11,000  Lease expense (amortization of lease incentive) $ 11,000  *To record amortization of the lease incentive. The remaining lease incentive of $88,000 is amortized over the remaining lease term ($88,000 ÷ 8 years = $11,000).*  Lessee would record similar entries in years 4 through 10.  **Journal entries under Approach 3**  The journal entries under Approach 3 in years 1 and 2 would be the same as under Approach 2, except for the entry for incentive amortization in year 2, which would be recorded as follows under Approach 3:  Right-of-use asset (amortization of lease incentive) $ 19,000  Lease expense (amortization of lease incentive) $ 19,000  *To record amortization of the lease incentive. Lessee would recognize annual amortization expense as if the incentive were paid or payable at the lease commencement date (i.e., $100,000 ÷ 10 years =*  *$10,000). This would require Lessee to recognize an additional $9,000 in amortization expense in year 2 as a cumulative adjustment as though the full amount of the incentive was recognized at lease commencement (i.e., $10,000, minus the $1,000 already expensed in year 1).*  The journal entries under Approach 3 would be the same as under Approach 1 in years 3 through 10.  Refer to Illustration 2-12 for a summary of the lease expense, ROU asset and lease liability amounts at lease commencement, the end of year 1, the end of year 2 and the end of year 3 under Approaches 2 and 3 as well as a comparison to Approach 1. |

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| **Illustration 2-12: Summary of lessee accounting for lease incentives not paid or payable at commencement under the three approaches** | | | | | | |
| Based on the journal entries depicted above in Illustrations 2-8 and 2-9, Lessee would have the following lease expense, ROU asset and lease liability amounts at lease commencement, the end of year 1, the end of year 2 and the end of year 3 under the three approaches. Immaterial differences may arise in the recomputation of amounts due to rounding. | | | | | | |
|  |  | **Accounts** | **Approach 1** | **Approach 2** | **Approach 3** |  |
|  | **Lease commencement** | **Lease liability ROU asset** | $ 6,472,000  $ 6,472,000 | $ 6,554,000  $ 6,554,000 | |  |
|  | **Year 1** | **Lease expense** | $ 840,000 | $ 849,000 | |  |
|  | **Ending lease liability** | $ 5,956,000 | $ 5,956,000 | |
|  | **Ending ROU asset** | $ 5,956,000 | $ 5,947,000 | |
|  | **Year 2** | **Lease expense** | $ 840,000 | $ 839,000 | $ 831,000 |  |
|  | **Ending lease liability** | $ 5,494,000 | $ 5,494,000 | $ 5,494,000 |
|  | **Ending ROU asset** | $ 5,414,000 | $ 5,406,000 | $ 5,414,000 |
|  | **Year 3** | **Lease expense** | $ 840,000 | $ 839,000 | $ 840,000 |  |
|  | **Ending lease liability** | $ 4,919,000 | $ 4,919,000 | $ 4,919,000 |
|  | **Ending ROU asset** | $ 4,849,000 | $ 4,842,000 | $ 4,849,000 |

Refer to section 4.2.1.2, *Initial measurement of right-of-use assets — operating leases*, or section 4.3.1.2, *Initial measurement of right-of-use assets* — *finance leases*, for further discussion of initial measurement by lessees.

Lessor

For lessors, lease incentives that are paid or payable to the lessee also are deducted from lease payments and affect the lease classification test. Lease incentives that are payable to the lessee at commencement reduce the initial measurement of the lessor’s net investment in the lease for sales-type and direct financing leases.

However, if lease incentives have been paid to the lessee prior to the commencement date, we believe that they affect the calculation of selling profit or loss for sales-type and direct financing leases (refer to section 5.1.3, *Selling profit or selling loss*). For operating leases, lessors should defer the cost of any lease incentives paid or payable to the lessee and recognize that cost as a reduction to lease income over the lease term (refer to section 5.4.2, *Lease incentives in an operating lease*).

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

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| **Illustration 2-13: Lessor accounting for a sales-type lease with a lease incentive paid at lease commencement** |
| On 1 January 20X1 (the commencement date of the lease), Lessor leases equipment for 10 years. Lessee agrees to a fixed payment of $15,000 per year, due 31 December of each year. Lessee guarantees the residual value for $30,000. The unguaranteed residual value is $20,000. To incentivize Lessee to enter into the lease, Lessor pays Lessee $5,000 on the lease commencement date.  At lease commencement, the equipment has a carrying amount of $100,000 and a fair value of  $106,000. The present value of the lease payments, including the lease incentive, is $98,344, using a rate implicit in the lease of 10.078%. Lessor incurs no initial direct costs. The lease is classified as a sales-type lease because the present value of the lease payments, including the residual value guaranteed by Lessee, exceeds substantially all of the fair value of the underlying asset. At lease commencement, Lessor concludes it is probable it will collect the lease payments and any amount probable of being owed under the residual value guarantee provided by Lessee.  *Analysis:* Lessor records the net investment in the sales-type lease and lease incentive paid and derecognizes the underlying asset on the lease commencement date as follows:  Net investment in the lease $ 111,000(a) Cost of goods sold 92,344(b)  Revenue $ 98,344(d)  Property held for lease 100,000(e)  Cash 5,000(c)  (a) The net investment in the lease consists of (1) the present value of the 10 annual lease payments of $15,000 plus the present value of the guaranteed residual value of $30,000, both discounted at the rate implicit in the lease, which equals $103,344 (i.e., the lease receivable) and (2) the present value of the unguaranteed residual value of the asset of $20,000, which equals $7,656. Note that the net investment in the lease is subject to the same considerations as other assets when classifying its components as current or noncurrent assets in a classified balance sheet.  (b) Cost of goods sold is the carrying amount of the equipment of $100,000 less the present value of the unguaranteed residual asset of $7,656.  (c) Lease incentive payment made to lessee in cash on the lease commencement date. |

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| (d) Revenue equals the lease receivable, which consists of (1) the present value of the 10 annual lease payments of $15,000 plus (2) the present value of the guaranteed residual value of $30,000, both discounted at the rate implicit in the lease, which equals $103,344, less (3) the $5,000 lease incentive payment.  (e) $100,000 is the carrying amount of the underlying asset.  At lease commencement, Lessor recognizes selling profit of $6,000, which is calculated as (1) revenue of $98,344 less (2) cost of goods sold of $92,344.  The following journal entries would be recorded in Year 1:  Cash $ 15,000(f)  Net investment in the lease $ 3,313(g)  Interest income 11,187(h)  *Year 1 journal entries for the sales-type lease.*  (f) Receipt of annual lease payment at the end of the year.  (g) Reduction of the net investment in the lease for lease payment received of $15,000 less interest income of $11,187.  (h) Interest income equals 10.078% multiplied by the net investment in the lease at the beginning of Year 1, $111,000.  Immaterial differences may arise in the recomputation of amounts in the example above due to rounding. |

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| **Illustration 2-14: Lessor accounting for a sales-type lease with a contingent lease incentive payment** |
| Assume the same facts as in Illustration 2-13, only in this illustration Lessor will only pay Lessee the  $5,000 lease incentive payment contingent upon certain events occurring after lease commencement (e.g., Lessee incurring $5,000 of costs to construct leasehold improvements). Lessor determines the payment of this lease incentive is probable at the lease commencement date and is expected to be made at the end of Year 3. Therefore, the present value of the lease payments, including the lease incentive payable, is $98,500, using a rate implicit in the lease of 10.305%.  Lessor incurs no initial direct costs. The lease is classified as a sales-type lease because the present value of the lease payments, including the residual value guaranteed by Lessee, exceeds substantially all of the fair value of the underlying asset. At lease commencement, Lessor concludes that it is probable it will collect the lease payments and any amount probable of being owed under the residual value guarantee provided by Lessee.  *Analysis*: Because payment of the lease incentive is probable at lease commencement, the lease incentive reduces the net investment in the lease. Lessor records the net investment in the sales-type lease and derecognizes the underlying asset on the commencement date as follows:  Net investment in the lease $ 106,000(a) Cost of goods sold 92,500(b)  Revenue $ 98,500(c)  Property held for lease 100,000(d)  *To record the net investment in the sales-type lease and derecognize the underlying asset.*  (a) The net investment in the lease consists of (1) the present value of the 10 annual lease payments of $15,000, plus the present value of the guaranteed residual value of $30,000, less the present value of the lease incentive expected to be paid at the end of Year 3, all discounted at the rate implicit in the lease, which equals $98,500 (i.e., the lease receivable) and (2) the present value of the unguaranteed residual value of the asset of $20,000, which equals $7,500. Note that the net investment in the lease is subject to the same considerations as other assets when classifying its components as current or noncurrent assets in a classified balance sheet.  (b) Cost of goods sold is the carrying amount of the equipment of $100,000 less the present value of the unguaranteed residual asset of $7,500.  (c) Revenue equals the lease receivable, which consists of (1) the present value of the 10 annual lease payments of $15,000 plus (2) the present value of the guaranteed residual value of $30,000 less (3) the present value of the lease incentive expected to be paid at the end of Year 3, all discounted at the rate implicit in the lease, which equals $98,500.  (d) $100,000 is the carrying amount of the underlying asset. |

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| At the end of Year 1, Lessor determines the payment of the contingent incentive payment remains probable and records the following entry:  Cash $ 15,000(e)  Net investment in the lease $ 4,077(f)  Interest income 10,923(g)  *Year 1 journal entries for the sales-type lease.*  (e) Receipt of annual lease payment at the end of the year.  (f) Reduction of the net investment in the lease for lease payment received of $15,000 less interest income of $10,923.  (g) Interest income equals 10.305% multiplied by the net investment in the lease at the beginning of Year 1, $106,000. |

##### Deposits paid before the lease commencement date

Lease contracts may require the lessee to pay the lessor a deposit before the lease commencement date. If the deposit is fully refundable, it represents collateral to the lessor. We believe that the fully refundable deposit payment and any market-rate-based interest earned by the lessor on the refundable deposit are not included as consideration in the contract. If the deposit payment is nonrefundable, it is in substance a fixed lease payment made by the lessee and is included as consideration in the contract. We also believe, if the deposit bears interest at a rate other than a market-based rate, the off-market portion of the interest is additional consideration in the contract as a lease incentive for the lessee (if above market) or as a lease payment for the lessee (if below market).

### Variable lease payments that depend on an index or rate

Variable lease payments that depend on an index or a rate are included in the lease payments and are measured using the prevailing index or rate at the measurement date (e.g., lease commencement date for initial measurement). The FASB indicated in the Basis for Conclusions (BC 211) of ASU 2016-02 that despite the measurement uncertainty associated with changes to index or rate-based payments, the payments meet the definition of an asset (lessor) and a liability (lessee) because they are unavoidable. Lessees and lessors recognize changes to index and rate-based variable lease payments in profit or loss in the period of the change (i.e., similar to other variable lease payments). Common examples of indexes and rates are:

* CPI
* Secured Overnight Financing Rate (SOFR)
* Prime interest rate
* Treasury rates (with or without a spread)
* Payments that depend on market rental rates

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

In some instances, a lease agreement will include a renewal option in which the payments during the renewal period are based on the market rental rates determined at or near the beginning of the renewal period. At lease commencement, if a lessee is reasonably certain to exercise the renewal option (refer to section 2.3.5, *Evaluating lease term and purchase options*), the lessee should include the payments during

the renewal period in lease payments similar to other variable lease payments that depend on an index or rate. Those payments should be measured using the market rental rates at the date of measurement (e.g., lease commencement date for initial measurement or remeasurement date upon reassessment of whether the lessee is reasonably certain to exercise the renewal option) for a lease with a term similar to the renewal period (e.g., a lessee should measure the payments during a three-year renewal period using the market rental rates for a three-year lease). That is, entities should not anticipate future rent increases (or decreases) when measuring lease payments for the future renewal periods included in the lease term.

Therefore, and similar to the discussion above on payments based on CPI, the lessee would not remeasure its lease payments when the lease payments are reset to market; instead, the lessee would recognize the effect of the changes in market rental rates as part of lease-related cost in the appropriate period (and disclosed as a variable lease cost). As a reminder, if the lease liability is reassessed for other reasons, the fixed lease payments are adjusted to the current index or rate. Refer to sections 2.4.11, *Subsequent remeasurement of lease payments*, and 4.10, *Disclosure*. Likewise, lessors should recognize the changes as income in the period they are earned.

In contrast, ASC 842 includes the following example of accounting for variable lease payments that do not depend on an index or rate. Refer to section 2.9, *Variable lease payments*:

### The exercise price of a purchase option

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

### Payments for penalties for terminating a lease

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

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

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

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

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

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

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

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| **Illustration 2-15: Residual value guarantee included in lease payments** |
| Lessee R enters into a lease and guarantees that Lessor S will realize $15,000 from selling the asset to another party at the end of the lease. At lease commencement, based on Lessee R’s estimate of the residual value of the underlying asset, Lessee R determines that it is probable that it will owe $6,000 at the end of the lease.  *Analysis*: In accordance with ASC 842-10-25-2, Lessee R and Lessor S will include the full guaranteed residual value of $15,000 for purposes of evaluating lease classification (refer to section 3.1, *Criteria for lease classification — lessees*, and section 3.2, *Criteria for lease classification — lessors*).  Because it is probable that Entity R will owe the lessor $6,000 under the residual value guarantee, Entity R includes that amount as a lease payment.  Refer to section 5.1.1, *Net investment in the lease,* for discussion of accounting for residual value guarantees by lessors in sales-type or direct financing leases. |

##### Third-party insurance that guarantees the asset’s residual value

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

##### Requirement for lessee to purchase the underlying asset

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

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

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

### Lessee’s obligations for asset retirement obligations (AROs) (updated July 2024)

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

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

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

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

Variable lease payments are defined as payments made by a lessee to a lessor for the right to use an underlying asset that vary because of changes in facts or circumstances occurring after the commencement date, other than the passage of time (refer to section 2.4.10, *Amounts not included in lease payments*)*.* Lease payments that depend on a factor directly related to the future use of the underlying asset, such as machine hours or sales volume during the lease term, are variable lease payments and, accordingly, are excluded from lease payments in their entirety. Increases or decreases in payments that result from variable lease payments are included in income as accruable.

Obligations imposed by a lease agreement to return the underlying asset to its original condition (if it has been modified by the lessee by the installation of leasehold improvements, such as a building constructed on leased land) generally do not meet the definition of a lease payment or a variable lease payment and, therefore, should be accounted for by the lessee as an ARO. Said another way, if an improvement to the underlying asset has been recognized as an asset on the lessee’s balance sheet (i.e., leasehold improvements), any obligation to remove that lessee improvement on expiration of the lease should generally be accounted for as an ARO. For example, assume a lessee that leases retail space and installs its own improvements (e.g., customized build-out) has an obligation under the lease to remove the improvements at the expiration of the lease. The obligation to remove the leasehold improvements does

not arise solely because of the lease but instead is a direct result of the lessee’s decision to modify the leased space. Such costs would be excluded from lease payments and variable lease payments. We believe the lessee’s estimate of its ARO at lease commencement would be included in the measurement of the leasehold improvement to which it relates and not as a component of a right-of-use asset. Refer to our FRD, [***Asset retirement obligations***](https://www.ey.com/en_us/technical/accountinglink/financial-reporting-developments---asset-retirement-obligations), for further discussion of the accounting for an ARO.

In certain circumstances, it may be difficult to determine whether improvements are assets of the lessee or the lessor. In many cases, the conclusion, which can affect the determination as to whether removal costs should be accounted for under the provisions for accounting for leases (ASC 842) or the provisions for AROs (ASC 410-20), will be based on facts and circumstances. Guidance to assist in determining whether improvements should be considered assets of the lessee or the lessor can be found in ASC 842- 40-55-5. Sections 2.11, *Improvements to the underlying asset*, and 7.7, *Lessee involvement in asset construction (“build-to-suit” transactions)*, also discuss factors to consider in making this determination.

The following illustrations demonstrate the concepts discussed above.

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| **Illustration 2-16: Obligation as a result of lease contract** |
| **Land with cellular tower**  Entity A (lessee) leases vacant land from Entity B (lessor). Entity A has the right but not the obligation to construct a cellular tower on the property. If Entity A constructs the cellular tower on the property, it is obligated to return the land to its original condition at the end of the lease term. In this case, it is the construction of the cellular tower that imposes the liability on Entity A, not the lease of the land. If Entity A does not construct the cellular tower, it has no obligation under the lease. If it does construct the cellular tower, the tower would be recognized as a leasehold improvement, and the obligation to remove the tower would be an ARO.  Alternatively, if Entity A leases land and an existing cellular tower from Entity B and is required to demolish and remove the cellular tower at the end of the lease term, Entity A has assumed a direct obligation related to the underlying asset that arises upon entering into the lease rather than an obligation created by a future action. As a result, the estimated demolition and removal costs should be included in lease payments. By including the dismantling obligation in lease payments, the obligation will be included in the measurement of the lease liability and right-of-use asset, and the related expense will be recognized over the lease term. At the end of the lease term, a liability exists that would be reduced by the payments made to demolish and remove the cellular tower.  **Lease of office space**  A lessee leases office space with preexisting improvements (e.g., interior walls, carpeting) and is contractually obligated to remove these preexisting improvements upon expiration of the lease. Because the original condition of the underlying asset included the improvements and the lessee is leasing the space and improvements, the estimated removal obligation should be included in lease payments.  Alternatively, if the lessee pays to build out the space to configure it to its needs (e.g., interior walls and carpeting accounted for by the lessee as leasehold improvements) and is required to remove the improvements on expiration of the lease, it should account for the removal obligation as an ARO. The lessee is obligated to remove an asset that it constructed and recorded as an asset (i.e., a leasehold improvement).  If the lessee leases office space with both preexisting improvements (i.e., lessor assets) and additional lessee leasehold improvements, estimated costs to remove the improvements should be split between the preexisting improvements and the lessee improvements. Estimated costs to remove the preexisting improvements should be included in lease payments. The contractual obligation associated with the removal of the leasehold improvements constructed and accounted for by the lessee should be accounted for as an ARO. |

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| **Illustration 2-17: Obligation as a result of a legal obligation** |
| Entity A (lessor) owns a gas station that it leases to Entity B (lessee). The property includes preexisting underground fuel storage tanks*.*  **Scenario 1**  At lease commencement, there is a legal requirement to remove the preexisting underground fuel storage tanks in 10 years. Even though Entity A leases the gas station to another party, it remains legally obligated for removal of the underground storage tanks and must recognize an ARO.  If the lease agreement requires Entity B to remove the underground storage tanks at the end of the lease term, the estimated cost of removal would be included in the lease payments by Entity B and would have no effect on the requirement for Entity A to recognize an ARO under ASC 410-20 for its legal obligation to remove the storage tanks.  **Scenario 2**  At lease commencement, there is no legal requirement for removal of the underground storage tanks. However, the lease requires that if such a legal requirement is enacted during the lease term, Entity B is required to remove the underground storage tanks at the end of the lease.  Entity B would have to consider the facts and circumstances to determine whether to account for the estimated costs of removal of the underground storage tanks as a lease payment or variable lease payment. We believe that if the enactment of a law requiring removal of the underground storage tanks during the lease term is judged to be probable at lease commencement, the removal costs would be included in the lease payments and accounted for under the general provisions for accounting for leases under ASC 842. However, if the enactment of such a law is not judged to be probable at lease commencement, the estimated removal costs would be accounted for as a variable lease payment. If a legal requirement to remove the underground storage tanks is enacted during the lease term or it is determined that the enactment of such law is probable after lease commencement, Entity B would accrue the estimated costs of removal. |

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

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| **Illustration 2-18: Settlement of ARO prior to the end of the lease term** |
| A retailer signs a 10-year lease for space in a shopping mall. The lease terms include a requirement for the lessee to return the space to its original condition at the end of the lease. At commencement  of the lease, the retailer modifies the space by constructing various leasehold improvements  (e.g., merchandise displays, shelving to stock merchandise, flooring, checkout counters). The retailer estimates that the useful life of the improvements is five years, at which time they will all be replaced.  The obligating event to remove these leasehold improvements occurs when they are made, regardless of whether settlement is planned at the end of the lease term or at an earlier point in time. The asset retirement cost should be amortized over the five-year estimated useful life of the improvements, and the obligation should be accreted using the credit-adjusted risk-free rate over the same five-year term. If the retailer replaces the original leasehold improvements after five years, a settlement of the original ARO obligation should be recognized, and a new ARO obligation should be recorded related to any newly constructed leasehold improvements. |

Accounting for an ARO

Entities often plan to use leased equipment to perform asset retirement activities. If this is the case, the estimate of the gross cash flows to satisfy the ARO liability includes anticipated lease costs for equipment the entity plans to lease to perform asset retirement activities in the future. Therefore, the cost assumptions used to measure the fair value of the ARO asset and liability will include all anticipated lease costs and costs relating to the non-lease components of contracts the entity expects to enter into to perform the asset retirement activities. Lease costs include lease payments as defined by ASC 842 and other payments associated with the lease component of the contract such as variable payments that are not dependent on an index or a rate.

Under ASC 842, a lessee is generally required to recognize a lease liability and a right-of-use asset for underlying assets, including underlying assets that are used in asset retirement activities, on the lease commencement date (i.e., the date the underlying asset is available for use by the lessee and not the date on which the ARO is recognized). This lease liability is recognized separately from any ARO liability even though the entity may have included an estimate of the lease costs in its measurement of the ARO (consistent with accounting for other obligations also included in the estimate of the ARO, such as employee payroll costs). That is, the entity recognizes one obligation to retire a long-lived asset or assets in accordance with ASC 410-205 and at the lease commencement date, a separate obligation to the lessor of the leased equipment in accordance with ASC 842. This is not a “double counting” of the lease obligation but instead reflects two separate obligations to different parties (i.e., an obligation associated with the retirement of a long-lived asset and a separate lease obligation).

AROs are generally settled in the periods the asset retirement activities are performed. As noted above, recognition of an ARO liability and the lease obligation are separately recognized obligations. Therefore, the recording of the lease liability doesn’t change the existence of the ARO. However, an entity should revise its estimates of lease costs used in measuring the ARO whenever indicators suggest that the assumptions regarding the future lease costs have changed, including at the commencement date of a lease contract for equipment that will be used to perform the asset retirement activities (i.e., when the terms of the lease arrangement are known).6

In the periods that a lessee uses an underlying asset for asset retirement activities, lease costs

(i.e., operating lease cost or amortization associated with the lease of a finance lease) recognized in accordance with ASC 842 are recorded as a reduction to the ARO liability, rather than as lease expense. Refer to section 4, *Lessee accounting*, for a further discussion of lease accounting.

The ASC 842 lessee disclosure requirements also apply once the lease has been entered into, even though the lessee will recognize lease costs as a reduction of the ARO. Therefore, entities will need to track total lease costs, including amounts that relate to asset retirement activities.

The graphic below illustrates both the accounting at key points in time and the periodic accounting journal entries an entity would make when using an underlying asset to perform asset retirement activities and assumes the lease commencement date occurs after the end of the useful life of the asset being retired.

Key points in time

**ARO incurred**

**Decommissioning work begins; lease commences**

|  |  |
| --- | --- |
| * Recognize ARO asset and liability | * ARO asset has been fully depreciated * ARO liability recognized based on accretion to date and any changes in estimated cash flows * Separately recognize ROU asset and lease liability at lease commencement date |

**Periodic journal entries**

**Accounting before the decommissioning period**

**Accounting during the decommissioning period**

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| --- | --- |
| * Recognize accretion expense associated with the ARO liability * Record ARO asset depreciation expense over the asset’s   useful life   * Reevaluate and remeasure ARO in accordance with ARO guidance, whenever assumptions change significantly | * Subsequently measure lease liability and ROU asset in accordance with ASC 842 following lease commencement date * Reduce ARO liability by lease costs (i.e., operating lease expense or amortization expense associated with a finance lease) recognized in each period * Recognize accretion expense associated with the ARO liability * Reduce ARO liability for other amounts used to settle the obligation * Recognize any gain or loss on settlement, as required by ASC 410-20 |

The requirements of ASC 410-20 do not apply to obligations of a lessee that meet the definition of either lease payments or variable lease payments in connection with the underlying asset, whether imposed by a lease agreement or by a party other than the lessor.

The following illustration shows the accounting considerations for an entity that leases equipment used in asset retirement activities. While the illustration shows the considerations for an operating lease, the principles of this example would also apply to finance leases.

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| **Illustration 2-19: Using leased equipment for decommissioning activities** |
| Assume that an upstream oil and gas entity (Upstream Co.) begins production on an oil field with an expected producing life of 10 years, followed by a three-year period of rehabilitation and decommissioning of the field that Upstream Co. is legally obligated to perform. Also, assume the following:   * The production activities involve the use of land not in the scope of ASC 842 (i.e., ASC 842 does not apply to leases to explore for or use non-regenerative resources). * On the date production begins, Upstream Co. estimates and records an ARO liability.1 * At the end of the 10-year field life, the reserves are fully depleted.2 * The ARO liability estimate includes expected payments of $21 million to a third-party lessor that Upstream Co. expects to make to lease a specialized drilling rig it plans to use in the asset retirement activities. * At the end of year 10, Upstream Co. enters into a three-year lease, classified as an operating lease, with the third-party supplier for the right to use the specialized drilling rig exclusively in the decommissioning process. For simplicity: * The terms of the lease are consistent with the assumptions used to measure the ARO liability. |

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| * The lease requires Upstream Co. to make a single lease payment of $21 million at the end of the three-year term, and there are no variable lease payments, meaning annual lease cost is $7 million. * Upstream Co. incurred no initial direct costs in connection with the lease and concludes the lease is an operating lease. * Annual accretion of the lease liability will be $1 million per year. * Upstream Co. recognizes a lease liability at the lease commencement date of $18 million.3   *Analysis:* The journal entries below illustrate select accounting implications of this fact pattern. Refer to Example 1 in Appendix A, *Comprehensive examples,* of our FRD, [***Asset retirement obligations***](https://www.ey.com/en_us/technical/accountinglink/financial-reporting-developments---asset-retirement-obligations)*,* for an example of the applicable ARO journal entries and section 4, *Lease accounting,* for a discussion of lessee accounting.  At the lease commencement date, Upstream Co. recognizes the right-of-use asset and lease liability: Right-of-use asset $ 18,000,000  Lease liability $ 18,000,000  *To initially recognize the right-of-use asset and lease liability.*  The following journal entries, among others, would be recorded in the first year of decommissioning: Lease expense $ 7,000,000  Right-of-use asset $ 6,000,000  Lease liability 1,000,000  *To recognize the lease cost of $7 million ($21 million over the three-year operating lease term, on a straight-line basis) for the use of the underlying asset and to adjust the lease liability to the present value of the remaining lease payments.*  ARO liability $ 7,000,000  Lease expense $ 7,000,000  *To reclassify lease expense to the ARO liability due to the use of the underlying asset for retirement activities.*  1 Refer to Example 1 in Appendix A, *Comprehensive examples,* of our FRD, [***Asset retirement obligations****,*](https://www.ey.com/en_us/technical/accountinglink/financial-reporting-developments---asset-retirement-obligations)for an example of the initial measurement of an ARO using the expected cash flow approach and subsequent measurements assuming there are no changes in the expected cash flows.  2 This liability will be accreted until settlement of the obligation (these subsequent accretion entries are not included for purposes of this illustration).  3 Refer to section 4.2.4, *Example — lessee accounting for an operating lease,* for an example of lease accounting journal entries for an operating lease. |

Refer to our FRD, [***Asset retirement obligations***](https://www.ey.com/en_us/technical/accountinglink/financial-reporting-developments---asset-retirement-obligations), for further discussion on the accounting for asset retirement obligations, including further discussion regarding the effect of applying the provisions of ASC 820, *Fair Value Measurement*, to the measurement of asset retirement obligations.

Question 2-3 How should an airline assess the provisions in a contract that require the return of a leased aircraft’s airframe and engines to the lessor in a certain condition or for the airline to pay an amount to the lessor based on the airframe and/or engine’s actual condition when returned? (added July 2024)

Often, a leased aircraft is expected to be returned to the lessor with a certain amount of eligible flight time left on both engines and airframes before the aircraft’s next maintenance event as defined in the lease agreement. There can also be other return conditions in lease arrangements (e.g., a requirement to

remove leasehold improvements). Airlines need to carefully consider whether these lease return conditions are accounted for under ASC 410-20, *Asset Retirement and Environmental Obligations — Asset Retirement Obligations*, or under ASC 842.

Lease return conditions resulting from a modification the lessee makes to the leased asset (e.g., a requirement to remove leasehold improvements) generally would not meet the definition of lease payments or variable lease payments and would be accounted for under ASC 410-20. In contrast, the costs to perform maintenance on an airframe or engine or to reimburse the lessor for having to incur those costs (because the airframe and engine would have less than the eligible flight time at the time of return) generally would be considered lease payments or variable lease payments (not based on an index or rate) and accounted for under ASC 842.

### Tax indemnifications in lease agreements

Indemnities for changes in tax laws

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

*Lessors*

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

*Lessees*

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

Therefore, to the extent a general indemnity requires additional payments to the lessor due to adverse changes in the tax law, regulations or ruling, the indemnification would generally be subject to ASC 460.

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| **Illustration 2-20: Accounting for indemnity for changes in tax laws** |
| Assume a lessor in an operating lease is a foreign entity that is not subject to tax withholding requirements and the lessor requires the lessee to indemnify the lessor for any future change in the tax law, which would require the lessee to withhold income taxes from payments to the lessor. This may occur if the lessor’s taxing authority enters into or modifies its tax treaty with the US. The effect of this indemnification would be to increase the lessee’s payments for the underlying asset for the required withholding tax (which would be remitted directly to the IRS).  *Analysis:* This arrangement meets the criteria of ASC 460-10-15-4(c), and therefore, the indemnity is subject to the recognition and measurement provisions of ASC 460. Therefore, the lessee should record a liability for the guarantee based on its fair value, and the related expense should be recognized over the operating lease term. |

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

General indemnity for increase in taxes

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

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

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

### Amounts not included in lease payments (updated August 2023)

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

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

A lessee’s guarantee of a lessor’s debt

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

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

Amounts allocated to non-lease components

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

Leasehold improvements recognized in a lease between entities under common control

Lease payments do not include leasehold improvements that are expected to be transferred from the lessee to a lessor that is under common control when the lessee no longer controls the use of the underlying asset (i.e., at the end of the lease). Refer to section 4.7.3.4, *Lessee amortization of leasehold improvements associated with a lease between entities under common control,* for further discussion.

### Subsequent remeasurement of lease payments

##### Subsequent remeasurement of lease payments — lessees

ASC 842 requires lessees to remeasure lease payments when there is a lease modification (i.e., a change to the terms and conditions of the contract that results in a change in the scope of or the consideration for the lease) that is not accounted for as a separate contract. Refer to the section 4.6, *Lease modifications*.

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

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| --- | --- | --- |
| **Title** | **Description of remeasurement event** | **Section reference** |
| **Resolution of contingency fixing previously variable lease payments** | A resolution of a contingency that results in some or all of the lease payments that were previously determined to be variable meeting the definition of lease payments (e.g., an event occurs that results in variable lease payments that were linked to the performance or use of the underlying asset becoming fixed payments for the remainder of the lease term)  This provision does not apply to variable payments based on an index or rate | * + 1. , *Fixed (including in-substance fixed) lease payments and lease incentives*     2. , *Variable payments that depend on an index or rate* |
| **Lease term** | A change in the lease term | * + 1. , *Lease term* |
| **Exercise of options** | A change in the assessment of whether the lessee is reasonably certain to exercise an option to purchase the underlying asset | 2.3.2, *Purchase options* |
| **Residual value guarantee** | A change in the amounts it is probable that the lessee will owe under residual value guarantees | 2.4.6, *Amounts it is probable that a lessee will owe under residual value guarantees — lessees only* |

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

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

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

Co-tenancy clause

A co-tenancy clause is a clause in a lease contract that could result in changes in a tenant’s lease payments if certain events involving other tenants occur (e.g., if key tenants or a certain number of tenants leave a retail shopping center). A co-tenancy clause, if triggered, may temporarily reduce a lessee’s lease payments or contractually change the lease payments from fixed lease payments to variable lease payments (e.g., payments that were previously fixed are changed to a percentage of sales). Generally, when the co-tenancy clause is resolved (e.g., the anchor tenant is replaced or occupancy levels return to a stated percentage), the lease payments will revert back to the previous amounts.

If after lease commencement a co-tenancy clause is triggered, we believe a lessee generally would not remeasure the lease payments. ASC 842 requires a lessee to remeasure lease payments when a contingency upon which some or all of the variable lease payments that will be paid over the remainder of the lease term are based is resolved and those payments now meet the definition of lease payments. A co-tenancy clause would typically result in the inverse scenario because it would temporarily lower the lease payment or temporarily cause fixed payments to become variable. Therefore, we believe any temporary change in lease payments that results from a co-tenancy clause being triggered should be recognized as period lease cost similar to variable lease payments.

However, in certain circumstances, when it is likely the co-tenancy clause will not be resolved (e.g., the lease space is an aging strip mall with a low likelihood of locating replacement tenants that comply with the clause), we believe a lessee may reasonably conclude it should remeasure the lease payments. In this example, the lease payments would be remeasured, resulting in a reduction to the existing lease liability.

The effect of a co-tenancy clause when reassessing lease payments will depend on facts and circumstances.

##### Subsequent remeasurement of lease payments — lessors

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

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

## Discount rates

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

For a lessee, the discount rate for the lease is the “rate implicit in the lease” and, if that rate cannot be readily determined, its incremental borrowing rate (or for a lessee that is not a PBE, the risk-free rate if the lessee has made the risk-free rate election for that class of underlying asset). For a lessor, the discount rate for the lease is the rate implicit in the lease. The rate implicit in the lease reflects the nature and specific terms of the lease. The rate implicit in the lease should not be less than zero, and we believe the incremental borrowing rate also should not be less than zero.

### Discount rate — lessors

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

**+ = +**

Any deferred initial direct costs of the lessor (see below and section 2.6, *Initial direct costs*)

The fair value of the underlying asset minus any related investment tax credit retained and expected to be realized by the lessor (refer to section 2.8, *Fair value*)

The present value of the amount the lessor expects to derive from the underlying asset following the end of the lease term (see below)

The present value of lease payments made by the lessee for the right to use the underlying asset (refer to section 2.4, *Lease payments*)

The amount the lessor expects to derive from the underlying asset

For purposes of determining the present value of the amount the lessor expects to derive from the underlying asset at the end of the lease, inflation generally is not considered. The estimated fair value of the underlying asset at the end of the lease is based on prices and market conditions that exist at the commencement of the lease. Therefore, we believe the amount used to determine the rate implicit in the lease would not exceed the fair value at lease commencement.

Initial direct costs — classification

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

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

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

Initial direct costs — initial recognition and measurement

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

Selling profit — initial recognition and measurement (direct financing leases)

For purposes of the initial recognition and measurement of a direct financing lease, any selling profit is deferred and reduces the lessor’s net investment in the lease (refer to section 5.3.1, *Initial recognition and measurement — direct financing leases*). Therefore, a lessor of a direct financing lease would exclude selling profit from the calculation of the rate implicit in the lease. That is, when calculating the rate implicit in the lease, the sum of (1) the present value of lease payments made by the lessee for the right to use the underlying asset and (2) the present value of the amount the lessor expects to derive from the underlying asset following the end of the lease term would be reduced by the selling profit.

### Discount rate — lessees (updated August 2023)

Lessees are required to use the rate implicit in the lease as described above if that rate can be readily determined. The rate implicit in the lease would be considered readily determinable when all of the inputs used to calculate the rate are readily determinable. We believe that lessees often will not know the amount of the lessor’s initial direct costs or the amount the lessor expects to derive from the underlying asset following the end of the lease term and, therefore, will be unable to determine the rate implicit in the lease. When the lessee cannot readily determine that rate, the lessee uses its incremental borrowing rate. The lessee’s incremental borrowing rate is the rate of interest that the lessee would have to pay to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment.

For purposes of determining a lessee’s incremental borrowing rate, a collateralized borrowing should also assume the lender can seek recourse through other assets of the lessee borrower. A lessee should start with the general credit of the company and then adjust the rate to reflect the effect of collateral on the incremental borrowing rate. However, the borrowing generally should not be over collateralized. The incremental borrowing rate cannot be a risk-free rate, unless the entity is a non-PBE that elects to apply a risk-free rate (refer to further discussion below).

When an entity identifies a borrowing with a “similar term,” we believe the entity can either:

* Evaluate the term relative to the lease term determined at the lease commencement date (i.e., any options not deemed reasonably certain of exercise at lease commencement, such as termination or extension options, would not be considered in the term of the debt). Under this approach, the incremental borrowing rate is not adjusted to consider purchase, renewal or termination options not included in the lease term.
* Use the same approach as above; however, the incremental borrowing rate is adjusted to reflect the lessee’s option to extend or terminate the lease or to purchase the underlying asset not otherwise included in the lease term. This view is consistent with the guidance in ASC 842-20-35-5 on remeasuring the lease liability (refer to section 4.5, *Remeasurement of lease liabilities and right-of- use assets — operating and finance leases*).

Non-PBE accounting policy election

A lessee that is not a public business entity (PBE) is permitted to make an accounting policy election to use the risk-free rate (e.g., in the US, the rate of a zero-coupon US Treasury instrument) by class of underlying asset for the initial and subsequent measurement of lease liabilities. The risk-free rate is determined using a period comparable with the lease term. A lessee is still required to use the rate implicit in the lease for any individual lease for which it is readily determinable, as described above, even if it has made the risk-free rate election for the associated class of underlying asset. If a lessee makes this election, it is required to disclose the class or classes of underlying assets to which it applied the risk-free rate in the notes to the financial statements.

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

At an October 2020 Center for Audit Quality (CAQ) SEC Regulations Committee joint meeting with the SEC staff, the SEC staff stated that it would not object to a registrant calculating the significance of an acquisition of a non-PBE lessee that previously elected to use a risk-free rate as its discount rate using the lessee’s pre-acquisition financial statements if the only difference between those financial statements and a set of PBE financial statements is the use of the risk-free rate. The SEC staff observed that the risk- free rate may result in higher calculated significance.

The SEC staff also shared its view that the financial statements of a lessee that previously elected to use the risk-free rate and is only considered to be a PBE now because its financial statements are included in another entity’s SEC filing (e.g., S-X Rule 3-05 financial statements) must use the rate implicit in the lease, if readily determinable, or its IBR in the financial statements included in the filing. That is because entities considered PBEs for this reason are required to provide financial statements that reflect the recognition and measurement principles applicable to PBEs.

A lessee should consider its future plans, such as its potential to become a PBE, when deciding whether to elect to use the risk-free rate. Electing to use the risk-free rate could increase complexity for a lessee that becomes a PBE because this election cannot be applied by a public company and would require the lessee to make a retrospective change in accounting policy in accordance with ASC 250.

##### Incremental borrowing rate when the lessee is unable to obtain financing

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

##### Subsidiaries’ incremental borrowing rate

The FASB indicated in the Basis for Conclusions (BC 201) of ASU 2016-02 that it might be appropriate in some cases for a subsidiary to use its parent’s incremental borrowing rate as the discount rate. Determining whether it is appropriate to do so for a subsidiary’s lease will depend on the facts and circumstances. For instance, if a subsidiary does not have a separate treasury function and the group’s funding is managed centrally at the group level, the lease negotiation may result in the parent entity providing a guarantee of the lease. In this situation, it might be appropriate to use the parent’s incremental borrowing rate. In all cases the subsidiary would need to carefully evaluate its relationship with its parent, including any guarantees, to support the use of the parent’s incremental borrowing rate. Refer to Example 2 in ASC 842-20-55-18 through 55-20 in section 4.8.4, *Portfolio approach*, which illustrates the use of a parent’s IBR for a portfolio of leases.

### Reassessment of the discount rate

##### Reassessment of the discount rate — lessors

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

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

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

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

##### Reassessment of the discount rate — lessees

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

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

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

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

## Initial direct costs

Under ASC 842, initial direct costs are incremental costs that would not have been incurred if the lease had not been obtained (e.g., commissions, payments made to an existing tenant to incentivize that tenant to terminate its lease). Lessees and lessors apply the same definition of initial direct costs.

ASC 842’s guidance on initial direct costs is consistent with the concept of incremental costs of obtaining a contract in the revenue recognition standard.

The following illustrates costs that may qualify as initial direct costs and costs that may not qualify as initial direct costs:

|  |  |  |
| --- | --- | --- |
| **Costs that may qualify as IDCs**   * Commissions paid to a salesperson when a lease agreement is obtained * Payments made to existing tenants to incentivize them to terminate the lease |  | **Costs that may not qualify as IDCs**   * Fees for general legal and tax advice * Costs of evaluating a prospective lessee’s   financial condition   * Commissions paid to a salesperson for entering into lease negotiations that is paid even if the lease is not obtained * General overheads |

In some cases, a lessee may receive a payment from a third party in connection with the execution of a lease agreement. Such payments should be evaluated carefully to determine whether other GAAP applies to the arrangement (e.g., whether the payments received are in exchange for fulfillment of a performance obligation under ASC 606; consideration received from a government grant). If other GAAP does not apply, we believe, in some circumstances, a lessee would recognize a payment received in connection with the execution of a lease agreement as a negative initial direct cost. For example, we believe this may be appropriate when a lessee’s arrangement with its real estate broker requires the broker to share a portion of its fee from the lessor for executing the lease with the lessee.

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

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

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

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

\* As discussed in section 2.5.1, *Discount rate — lessors*, for purposes of performing the sales-type lease classification test only, a lessor assumes that no initial direct costs will be deferred (i.e., initial direct costs are excluded from the calculation of the rate implicit in the lease) if, at the commencement date, the fair value of the underlying asset is different from its carrying amount. Refer to section 3.3, *Discount rates used to determine lease classification,* for further discussion. In certain circumstances, for lessors that are not manufacturers or dealers, the fair value of the underlying asset is their cost, less any volume or trade discounts. Refer to section 2.8, *Fair value*, for further discussion.

\*\* The FASB indicated in the Basis for Conclusions (BC 306) of ASU 2016-02 that its decisions on defining, allocating and accounting for initial direct costs were intended to align the accounting for initial direct costs by a lessor with the accounting for costs to obtain a contract by a seller of similar goods under ASC 340-40. Under ASC 340-40, an entity recognizes the contract cost asset into income when (or as) the related goods or services are transferred to the customer. When a lessor enters into a direct financing lease or a sales-type lease in which the fair value of the underlying asset is equal to its carrying amount, the good or service to which the asset (initial direct costs) relates is the lessor’s service of providing financing to the lessee. In contrast, in a sales-type lease in which the fair value of the underlying asset is different from its carrying amount, the lessor is generally a manufacturer or a dealer and leasing represents another means for the lessor to sell its products. The good or service to which the initial direct costs relate in those transactions is the underlying asset; control of which is effectively transferred to the lessee at lease commencement.

### Initial direct costs in a lease modification

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

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

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

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

Refer to sections 2.6, *Initial direct costs*; 2.8, *Fair value*; 4.6, *Lease modifications*; and 5.6, *Lease modifications*.

## Economic life

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

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

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

## Fair value

Lessees and lessors determine the fair value of the underlying asset in a lease arrangement for purposes of lease classification and measurement under ASC 842 using the definition of fair value in ASC 820.

That is, the fair value of the underlying asset in a lease arrangement is the price that would be received to sell the asset in an orderly transaction between market participants at the measurement date. ASC 820 provides a framework for measuring fair value and requires certain disclosures.

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

Fair value exception for lessors that are not manufacturers or dealers

Lessors that are not manufacturers or dealers (e.g., financial institutions and captive finance companies) calculate the fair value of the underlying asset at lease commencement at their cost, less any volume or trade discounts that may apply, for the purposes of lease classification and measurement. However, if there is a significant amount of time between the acquisition of the underlying asset and lease commencement, a lessor would have to measure the fair value using the guidance in ASC 820.

## Variable lease payments

Common examples of variable lease payments include:

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

### Lessee accounting for variable lease payments (updated August 2023)

Some rental agreements provide for fixed lease payments plus variable lease payments based on the lessee’s operations. Often, the specified targets are not achieved until later periods. This may occur despite the fact that achievement of the targets is considered probable at some earlier point. A lessee should recognize costs for variable lease payments in the period (annual as well as interim) in which the achievement of the specified target that triggers the variable lease payments becomes probable.

Previously recognized variable lease costs should be reversed in the period it becomes probable that the specified target will not be met. How these costs are reversed will depend on how they were previously recognized (i.e., in profit or loss or capitalized as part of the cost of another asset, such as inventory).

Probable in this context means the future event or events that will trigger the payment are likely to occur. This is the same threshold of probability that is used in ASC 450, *Contingencies*, with respect to the recognition of liabilities.

|  |
| --- |
| **Illustration 2-21: Lessee accounting for variable lease payments** |
| A rental agreement requires an additional payment of $1,000 if machine hours exceed 10,000 hours.  *Analysis:* The $1,000 annual payment should be accrued before the achievement of the specified target that triggers the variable lease payments if the achievement of that target, annual machine hours in excess of 10,000 hours, is considered probable. |

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Payment under lease agreement** | **Actual**  **annual sales** | **Calculated lease payment** |
| Year 1 | $15,000 | $200,000 |  |
| Year 2 | 5% of current year sales | $250,000 | $12,500 = $250,000 x 5% |
| Year 3 | 5% of current year sales | $300,000 | $15,000 = $300,000 x 5% |

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Recognition of Year 1 payment** | | **Recognition of Year 2 payment** | **Recognition of Year 3 payment** | **Total lease cost recognized** |
| Year 1 | $5,000 |  |  | $5,000 |
|  | ($15,000/3) |  |  |  |
| Year 2 | $5,000 | $12,500 |  | $17,500 |
|  | ($15,000/3) |  |  |  |
| Year 3 | $5,000 |  | $15,000 | $20,000 |
|  | ($15,000/3) |  |  |  |
|  |  |  |  | $42,500 |

Refer to section 2.4.2, *Variable lease payments that depend on an index or rate*, for an additional example of lessee accounting for variable lease payments.

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

In some instances, a lease contract includes fixed payments, including in-substance fixed payments, with no variable lease payments for a portion of the lease term and variable payments, with no fixed payments, for the remainder of the lease term. For example, a five-year lease may include fixed annual payments in years 1 and 2 and variable payments (not based on an index or rate) only in years 3 through 5.

The following example illustrates a lessee’s accounting for such a lease arrangement.

|  |
| --- |
| **Illustration 2-22: Lessee accounting: Fixed lease payments in the first year and variable lease payments thereafter** |
| Entity A (lessee) enters into a three-year lease of a retail space. Entity A agrees to make a payment of  $15,000 (i.e., a fixed payment) in Year 1. For Year 2 and Year 3, the payments will equal 5% of the lessee’s current year retail sales (i.e., variable payments not based on an index or rate). The table below illustrates the fixed and variable payments based on actual annual sales over the lease term. For simplicity, assume there are no non-lease components and the lease is classified as an operating lease by Entity A.  As noted above, Entity A concludes the lease is an operating lease. Therefore, the fixed lease payments are recognized as lease cost on a straight-line basis over the lease term, even though the payment may have been economically designed to compensate the lessor for the rent in Year 1. In addition, the variable lease payments are recognized in the period in which the achievement of the specified target that triggers the variable lease payments becomes probable (i.e., in the year of the retail sales in this example).  A summary of total amounts recognized as lease cost each year is as follows:  Lease cost is higher in the later years of the lease because the fixed payment is recognized on a straight-line basis over the lease term, and the variable lease payments cannot be estimated at lease commencement (i.e., they are recognized in the period in which the achievement of the specified target that triggers the variable lease payments becomes probable). |

### Lessor accounting for variable lease payments (updated August 2023)

A lessor should recognize income for variable lease payments in the period when changes in facts and circumstances on which the variable lease payments are based occur. This applies to both interim and annual periods and applies regardless of lease classification (i.e., applies to sales-type, direct financing and operating leases). For example, if a lessor receives contingent rent if the lessee’s sales exceed

$2,000,000 during the year, the lessor cannot recognize the variable lease payments until sales exceed this amount, regardless of probability. Consequently, it would be inappropriate to anticipate changes in the factors on which variable lease payments are based and recognize rental income prior to the occurrence of the change in factors on which variable lease payments are based. Refer to sections 5.2.2,

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Payment under lease agreement** | **Actual annual**  **sales** | **Calculated lease payment** |
| Year 1 | $15,000 | $200,000 |  |
| Year 2 | 5% of current year sales | $250,000 | $12,500 = $250,000 x 5% |
| Year 3 | 5% of current year sales | $300,000 | $15,000 = $300,000 x 5% |

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Recognition of Year 1 payment** | | **Recognition of Year 2 payment** | **Recognition of Year 3 payment** | **Total lease income recognized** |
| Year 1 | $5,000 |  |  | $5,000 |
|  | ($15,000/3) |  |  |  |
| Year 2 | $5,000 | $12,500 |  | $17,500 |
|  | ($15,000/3) |  |  |  |
| Year 3 | $5,000 |  | $15,000 | $20,000 |
|  | ($15,000/3) |  |  |  |
|  |  |  |  | $42,500 |

*Subsequent measurement — sales-type leases*, 5.3.2, *Subsequent measurement — direct financing leases*, and 5.4, *Operating leases*, for further discussion of accounting for variable lease payments by a lessor, and refer to Appendix F, *Variable payments – lessor*, for a flowchart illustrating how a lessor accounts for variable payments.

In some instances, a lease agreement will include fixed payments, including in substance fixed payments, with no variable lease payments for a portion of the lease term and variable lease payments, with no fixed lease payments, for the remainder of the lease term.

The following example illustrates a lessor’s accounting for such a lease arrangement.

|  |
| --- |
| **Illustration 2-23: Lessor accounting: Fixed lease payments in the first year and variable lease payments thereafter** |
| Entity B (lessor) enters into a three-year lease of a retail space. Entity A (lessee) agrees to make a payment of $15,000 (i.e., a fixed payment) in Year 1. For Year 2 and Year 3, the payments will equal 5% of the lessee’s current year retail sales (i.e., variable payments not based on an index or rate). The table below illustrates the fixed and variable payments based on actual annual sales over the lease term. For simplicity, assume there are no non-lease components, and the lease is classified as an operating lease by Entity B.  As noted above, Entity B concludes the lease is an operating lease. Therefore, the fixed lease payments are recognized as lease income on a straight-line basis over the lease term, even though the payment may have been economically designed to compensate the lessor for the rent in Year 1. In addition, the variable lease payments are recognized in the period when changes in facts and circumstances on which the variable lease payments are based occur (i.e., in the year of the retail sales in this example).  A summary of total amounts recognized as lease income each year is as follows:  Lease income is higher in the later years of the lease because the fixed payment is recognized on a straight-line basis over the lease term, and the variable payments, because they relate even partially to the lease, cannot be estimated at lease commencement (i.e., they are recognized in the period when changes in facts and circumstances on which the variable lease payments are based occur). |

### Embedded derivatives in variable lease payments

Derivative versus variable lease payments

Arrangements with variable lease payments may also contain embedded derivatives (i.e., features within the lease contract that would meet the definition of a derivative under ASC 815 on a standalone basis) that must be evaluated either pursuant to the “clearly and closely related” criteria of ASC 815-15 or to determine whether the embedded feature meets a specific scope exception from derivative accounting. If the embedded derivative is not considered to be “clearly and closely related” to the host contract

(i.e., the lease agreement) and there is not a specific scope exception that applies, ASC 815-15 requires that the embedded derivative(s) be bifurcated and accounted for separately from the host contract. The following examples illustrate the application of the “clearly and closely related” analysis or whether a specific scope exception applies to variable lease payments:

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

Refer to section 2.4.1.1, *In-substance fixed lease payments,* for a discussion of whether certain payments are lease payments, variable lease payments or derivatives and section 2.9.4, *Embedded foreign currency derivatives,* for a discussion of embedded foreign currency derivatives in lease arrangements. Our FRD, [***Derivatives and hedging***](https://www.ey.com/en_us/technical/accountinglink/financial-reporting-developments---derivatives-and-hedging), provides additional information and guidance about the subsequent accounting for embedded derivatives in lease arrangements that are accounted for separately pursuant to ASC 815-15.

### Embedded foreign currency derivatives

Lessees

For a finance lease denominated in a nonfunctional currency, the lessee’s lease liability is deemed to be a monetary item governed by the provisions of ASC 830, *Foreign Currency Matters*, and therefore would not be considered to contain an embedded foreign currency derivative, as the finance lease liability meets all of the criteria in ASC 815-15-15-5. While the lessee’s lease liability for operating leases denominated in a nonfunctional foreign currency meets the criteria in ASC 815-15-15-5(a) and (c), it is unclear whether payments on an operating lease could be viewed as principal and interest payments (ASC 815-15-15-5(b)). However, we believe that, consistent with other monetary items that are remeasured under ASC 830, bifurcation of the foreign currency embedded derivative in an operating lease denominated in a nonfunctional currency would not be required.

Lessors

For sales-type leases and direct financing leases denominated in a nonfunctional currency, the lessor’s

net investment in the lease is deemed a monetary item governed by the provisions of ASC 830

and therefore would not be considered to contain an embedded foreign currency derivative, as the net investment in the lease meets all of the criteria in ASC 815-15-15-5.

Operating leases denominated in a nonfunctional currency need to be evaluated under the embedded derivatives guidance in ASC 815-15. Specifically, a lessor in an operating lease agreement that includes lease payments denominated in a foreign currency needs to evaluate the guidance in ASC 815-15-15-10 in determining whether the embedded foreign currency derivative should be separated from the host contract and considered a derivative instrument under ASC 815.

When the host contract is not a financial instrument, ASC 815-15-15-10 provides that the bifurcation requirements do not apply (i.e., there is no requirement to separately account for an embedded foreign currency derivative) if the lease payments are denominated in any of the following currencies:

* The functional currency of any substantial party to the lease
* The local currency of any substantial party to the lease
* The currency used by a substantial party to the lease as if it were the functional currency because the primary economic environment in which that party operates is highly inflationary
* The currency in which the price of the underlying asset is routinely stated in international commerce (e.g., if it is current international practice for commercial jet leases to be denominated in US dollars)

The application of the phrase “routinely denominated in international commerce” should be based on how similar transactions are routinely structured around the world, not just in one local area. Therefore, if similar leases for a certain asset are routinely denominated in international commerce in various different currencies, the exception provided by ASC 815-15-15-10 does not apply to any of those similar transactions.

For purposes of evaluating whether an operating lease contains an embedded foreign currency derivative, a guarantor is not a substantial party to a two-party lease, even when it is a related party of the lessee or the lessor (e.g., a parent company guarantee provided to its subsidiary, even if the parent company consolidates the subsidiary). The substantial parties to a lease contract are the lessor and the lessee (ASC 815-15-55-84 through 55-86).

Generally, if lease payments are denominated in a currency other than the currency of the primary economic environment in which any substantial party to the operating lease contract operates (i.e., in most lease arrangements, the functional or the local currency of the lessee or the lessor), the operating lease would be considered to include an embedded foreign currency swap arrangement that should be separated from the host contract (i.e., the operating lease agreement) and considered a derivative instrument under ASC 815 (provided that a separate instrument with the same terms would meet the definition of a derivative instrument).

The evaluation of whether an operating lease qualifies for the exception is performed only at the inception of the contract.

For more guidance about the subsequent accounting for embedded derivatives in lease arrangements that are accounted for separately pursuant to ASC 815-15, refer to our FRD, [***Derivatives and hedging***](https://www.ey.com/en_us/technical/accountinglink/financial-reporting-developments---derivatives-and-hedging)*.*

## Other matters related to residual value guarantees

### Residual value guarantees as derivatives

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

Residual value guarantees that are subject to the guidance in ASC 842 are not subject to the requirements for derivative instruments under ASC 815. This “exception” only applies to residual value guarantees within the scope of ASC 842 (ASC 815-10-15-80). For example, a residual value guarantee obtained by a lessor from a third party after lease commencement (refer to section 2.2, *Commencement date of the lease*) would not be subject to ASC 842 and thus would potentially be subject to derivative accounting under ASC 815 if it meets the definition of a derivative (and does not qualify for any of the scope exceptions therein).

Additionally, a third-party residual value guarantor should evaluate the guidance in ASC 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 ASC 815-10. If such a guarantee is not in the scope of

ASC 815, then the recognition and measurement guidance in ASC 460 would apply.

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

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

### Residual value guarantee of a group of assets — lessees

In certain master lease agreements covering a group of assets, the lessee guarantees the residual value of the group of assets being leased as opposed to the residual value of each individual asset in the group. When evaluating the “substantially all” criterion of the lease classification test, we believe it would be acceptable in all cases for a lessee to include the full amount of the residual value guarantee for the group of underlying assets for each individual asset within the group (i.e., the “all-in” approach).

We also believe it would be acceptable in some arrangements to allocate the amount it is probable a lessee will owe under the residual value guarantee among all of the underlying assets on a pro rata basis in relation to the expected residual value at the end of the lease term of each asset (i.e., the pro rata approach). For example, if the amount probable of being owed under a group residual value guarantee is $180 and the total expected residual value of all of the underlying assets as of the end of the master lease term is $300, the residual value guarantee would be allocated to each asset based on 60% of each underlying asset’s expected residual value.

We believe the pro rata approach is acceptable only if the leases in the group are substantially the same. For example, use of the pro rata approach may be appropriate when the individual leases in the group are coterminous, the underlying assets are physically similar, and the variability associated with the expected residual values is expected to be highly correlated (i.e., one asset’s residual value is expected to be similar to that of the other assets’ residual values).

### Residual value guarantee of a group of assets — lessors

In some cases, the residual value insurance may be for a portfolio of assets rather than individual assets within the lease portfolio. Accordingly, when an asset has a residual value below the guaranteed amount, such a deficiency could be offset by assets that have residual values in excess of their guaranteed value. ASC 842-10-55-9 through 55-10 address a lessor’s accounting for residual value guarantees for a portfolio of underlying assets and state that residual value guarantees of a portfolio of underlying assets preclude a lessor from determining the amount of the guaranteed residual value of any individual underlying asset within the portfolio at lease inception, due to the netting of the residual value gains and losses. Therefore, ASC 842-10-55-10 states no amounts should be considered when evaluating the lease classification criteria. However, we believe if the assets in the portfolio are physically identical and have the same lease term, and the variability related to the expected residual values is expected to be highly correlated, it would be acceptable for a lessor to include an allocated portion of the residual value guarantee for the portfolio of underlying assets to determine the lease classification of the individual underlying assets. Refer to section 3.2, *Criteria for lease classification — lessors*, for further discussion of consideration of residual value guarantees in evaluating lease classification.

### Lessee guarantee of lessor’s return

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

### Third-party guarantee of lease payments or residual value

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

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

Exclusion provisions

In some cases, third-party residual value insurance contracts contain exclusion provisions that the contract does not represent a guarantee of the lessor’s residual value (that is, the residual value guarantee is only effective in limited circumstances). Many of the customary exclusion provisions, such as excess wear and tear or damages (which are typically the lessee’s responsibility), would be acceptable and not preclude consideration of the guaranteed residual value for lease classification purposes (i.e., whether the lease is a direct financing lease). However, exclusion provisions that substantially curtail the lessor’s ability to receive

a payment from the guarantor on disposition of the underlying asset at the end of the lease term (refer to section 2.3, *Lease term and purchase options*) would prevent the lessor from considering the guaranteed residual value. For example, a requirement that the lessee return the underlying asset to “like-new” condition at the end of the lease would not represent an effective guarantee of the asset’s residual value. Likewise, a requirement that the underlying asset be returned to a location that is economically unfeasible based on the anticipated location of the underlying asset and transportation costs to the specified location at the end of the lease term, or other requirements that severely restrict the lessor’s ability to dispose of the asset at or near market value at the end of the lease term, should be carefully evaluated.

Self-insurance and premiums based on loss experience — lessors

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

As further discussed in section 2.10.1, *Residual value guarantees as derivatives*, residual value guarantees that are subject to ASC 842 are excluded from the scope of ASC 815, *Derivatives and Hedging*.

## Improvements to the underlying asset

Entities should evaluate whether improvements made to the underlying asset are lessee or lessor assets because this conclusion may affect:

* Which entity recognizes the asset. For example, lessee improvements are capitalized by the lessee as leasehold improvements, and lessor improvements are capitalized by the lessor.
* Whether a lessor payment to the lessee for the improvements is a lease incentive or a reimbursement of the costs incurred by the lessee to build the improvements on the lessor’s behalf. For example, if a retailer leases general purpose retail space and has its own contractor build specific lessee improvements to make the store look like the others it operates around the Country (i.e., the improvements are lessee assets), any amounts the lessor provides to pay a portion of the cost will generally be viewed as an incentive. Lease incentives that are paid or payable to the lessee are deducted from lease payments, affect the lease classification test and may affect the initial measurement and subsequent accounting for the lease (e.g., for lessees, lease incentives that are paid or payable reduce the lessee’s ROU asset, and lease incentives that are payable to the lessee at lease commencement reduce a lessee’s lease liability). Refer to section 2.4.1.2, *Lease incentives*, for more information. In contrast, if the lessee leases fully built-out space and incurs costs to construct the space on the lessors’ behalf (e.g., a floor in an office building with interior walls and lighting), a lessor’s payment to the lessee for lessor improvements may be a reimbursement of the costs incurred by the lessee. If a lessee is not reimbursed for payments it makes or costs it incurs on a lessor’s behalf, those amounts are considered noncash lease payments (refer to section 2.4, *Lease payments*, for more information on noncash lease payments).
* The lease commencement date. For example, if the lessor provides the lessee with access to the leased space so that the lessee can begin to construct its own leasehold improvements (i.e., the improvements are lessee assets), the commencement date is the date the lessor made the underlying asset available for use by the lessee (refer to section 2.2, *Commencement date of the lease*).

In many instances, judgment will be required to determine whether the lessee is constructing lessee improvements (i.e., leasehold improvements) or lessor improvements (i.e., leasing built-out space). Examples of factors that would be considered in making the determination of whether improvements are lessee or lessor assets include:

* What happens to the improvements at the end of the lease term (i.e., whether they are removed or preserved for the landlord)
* How the economic life of the improvements compares to the lease term (i.e., whether the lease term is for substantially all of the economic life of the improvements)
* Whether the improvements are unique (e.g., they include the décor and logo of a national retail chain rather than general purpose improvements)
* Which party is supervising construction (i.e., whether the lessee is acting as an agent during the construction period or is actively involved in the design of the improvements)
* Which party bears all costs of the improvements (including the risk of cost overruns)
* Which party owns the improvements

We note that it would be inconsistent with the unit of accounting concept for a lessee to recognize a partial asset in its financial statements (e.g., lessor funds 60% of an asset and the lessee recognizes 40% as an asset in the lessee’s financial statements).

In addition, an entity’s determination about whether the improvements are lessee or lessor assets should be consistent across the various aspects of the guidance affected (e.g., which entity recognizes the asset, the accounting for lease incentives or reimbursement of costs, the determination of the commencement date of the lease).

### Leasehold improvements

Leasehold improvements are lessee assets that are capitalizable changes made to an underlying asset to customize it for a particular use or need of a lessee (e.g., a lessee that is leasing a commercial office space may construct its own interior walls or install its own carpeting). Amounts capitalized as attributable to leasehold improvements should be presented separately from the related ROU asset. Refer to section 4.7.3, *Amortization of leasehold improvements*, for more information on amortization of these assets.

# Lease classification

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

## Criteria for lease classification — lessees

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

* The lease transfers ownership of the underlying asset to the lessee by the end of the lease term (refer to section 3.4.1, *Transfer of ownership*).
* The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise (refer to section 2.3.5, *Evaluating lease term and purchase options*).
* The lease term (refer to section 2.3.1, *Lease term*) is for a major part of the remaining economic life (refer to section 2.7, *Economic life*) of the underlying asset. This criterion is not applicable for leases that commence at or near the end of the underlying asset’s economic life (refer to section 3.4.3, *Evaluating ‘major part,’ ‘substantially all’ and ‘at or near the end’*).
* The present value of the sum of the lease payments (refer to section 2.4, *Lease payments*) and any residual value guaranteed by the lessee7 (refer to section 3.4.5, *Residual value guarantees included in the lease classification test*) that is not already included in the lease payments equals or exceeds substantially all of the fair value (refer to section 2.8, *Fair value*) of the underlying asset (refer to section 3.4.3, *Evaluating ‘major part,’ ‘substantially all’ and ‘at or near the end’*).
* The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term (refer to section 3.4.7, *Alternative use criterion*).

Neither of the following forms of consideration affect lease classification: (1) indemnifications for environmental contamination (refer to section 3.4.8, *Lessee indemnifications for environmental contamination*) nor (2) a lessee’s guarantee of a lessor’s debt (refer to section 2.4.10, *Amounts not included in lease payments*).

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

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

The decision tree below summarizes the evaluation of lease classification for lessees under ASC 842:

**Finance lease**

Yes

No

**Purchase option reasonably certain to be exercised?**

**Transfer of ownership?**

No

No

**Present value (lease payments**

**+ any residual value guaranteed by lessee) ≥ substantially all of fair value?**

**Lease term = major part of economic life?**

No

**Specialized asset?**

No

Yes

Yes

Yes

Yes

**Operating lease**

## Criteria for lease classification — lessors

At lease commencement, a lessor classifies a lease as a sales-type lease if the lease meets **any one** of the criteria in section 3.1, *Criteria for lease classification — lessees,* and does not have a selling loss and has variable lease payments that are not based on an index or rate.

If none of the criteria in section 3.1, *Criteria for lease classification — lessees*, are met, a lessor classifies a lease as a direct financing lease when the lease meets **both** of the following criteria (and does not have a selling loss and has variable lease payments that are not based on an index or rate):

* The present value of the sum of lease payments and any residual value guaranteed by the lessee and **any other third party unrelated to the lessor** equals or exceeds substantially all the fair value of the underlying asset. As discussed in section 2.8, *Fair value*, in certain circumstances, for lessors that are not manufacturers or dealers, the fair value of the underlying asset is their cost, less any volume or trade discounts.
* It is probable that the lessor will collect the lease payments plus any amount necessary to satisfy a residual value guarantee.

Neither of the following forms of consideration affect lease classification: (1) indemnifications for environmental contamination (refer to section 3.4.8, *Lessee indemnifications for environmental contamination*) nor (2) a lessee’s guarantee of a lessor’s debt (refer to section 2.4.10, *Amounts not included in lease payments*).

For lessors, all leases not classified as sales-type leases or direct financing leases are classified as operating leases. Additionally, leases with variable lease payments that are not based on an index or rate (e.g., long-term leases of machinery where the consideration in the contracts is determined based on hours used by the lessee) are classified as operating leases if they would have otherwise been classified as sales-type or direct financing leases and the lessor would have recognized a selling loss at lease commencement. A lessor in this situation should keep in mind that it must also determine whether the underlying asset is impaired prior to lease commencement (e.g., by applying the impairment guidance in ASC 360-10). For example, if the selling loss that would be avoided by applying ASC 842-10-25-3A results from reasons other than just the variable lease payments (e.g., total expected lease payments, including the expected variable lease payments, are less than the carrying amount of the underlying asset), that would be an indicator under ASC 360-10 that the underlying asset is impaired before the lease commences. A key difference between the sales-type lease and direct financing lease classification tests is the treatment of residual value guarantees provided by unrelated third parties other than the lessee. Those third-party guarantees are excluded from the evaluation of the “substantially all” criterion in the sales-type lease test. However, they are included in the evaluation in the direct financing lease test. In addition, the evaluation of the collectibility of lease payments and residual value guarantees affects direct financing lease classification, whereas it does not affect sales-type lease classification. However, the evaluation of collectibility does affect sales-type lease recognition and measurement.

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

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

Yes

No

Yes

No

**Direct financing lease^**

**Sales-type lease\*^**

Does the lease meet **any one** of the criteria in section 3.1, *Criteria for lease classification — lessees* (ASC 842-10-25-2)?

Does the lease meet **both** of the following criteria in section 3.2, *Criteria for lease classification — lessors* (ASC 842-10-25-3)?

* The present value of the sum of the lease payments and any residual value guaranteed by the lessee and any other third party unrelated to the lessor equals

or exceeds substantially all the fair value\*\* of the underlying asset.

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

**Operating lease**

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

\*\* As discussed in section 2.8, *Fair value*, in certain circumstances, for lessors that are not manufacturers or dealers, the fair value of the underlying asset is their cost, less any volume or trade discounts.

^ Lessors are required to classify leases as operating leases if they have variable lease payments that do not depend on an index or rate and would result in selling losses if they were classified as sales-type or direct financing leases.

### Evaluating collectibility

Collectibility refers to the lessee’s ability and intent to pay the lease payments and any guaranteed residual value. A lessor should assess a lessee’s ability to pay based on the lessee’s financial capacity and its intention to pay, considering all relevant facts and circumstances, including past experiences with that lessee or similar lessees. Collectibility determinations must be made on a lease-by-lease basis or using a portfolio approach when “the entity reasonably expects that the application of the leases model to the portfolio would not differ materially from the application of the leases model to the individual leases in that portfolio.” These collectibility determinations can affect the classification of a lease between a direct financing or operating lease (refer to section 3.2, *Criteria for lease classification — lessors)* and the recognition and measurement of income on a sales-type and operating lease. Refer to section 5.2.1.2, *Initial recognition and measurement when collectibility is not probable at lease commencement — sales-type leases,* for a discussion of the accounting for sales-type leases when collectibility is not probable and section 5.4, *Operating leases,* for considerations related to operating leases when collectibility is not probable. Additionally, refer to section 5.7.4.1, *Portfolio approach*, for considerations relating to the use of a portfolio approach.

### Lease classification for certain sales that include a residual value guarantee in the form of a repurchase option (lessors only)

An entity that sells equipment may guarantee that the customer will receive a minimum resale amount when the customer resells the equipment (i.e., a residual value guarantee). If the residual value guarantee is in the form of a repurchase provision (e.g., the customer has a contractual put option to require the entity to repurchase equipment two years after its initial purchase at 85% of the price the customer paid), the seller would first evaluate the guidance in ASC 606 on repurchase arrangements and determine whether the existence of the repurchase provision precludes the customer from obtaining control of the acquired item. Refer to section 7.3.2, *Put option held by the customer*, of our FRD, [***Revenue from contracts with customers (ASC 606)***](https://www.ey.com/en_us/technical/accountinglink/financial-reporting-developments---revenue-from-contracts-with-c), which discusses the guidance requiring an arrangement to be accounted for as a lease if the seller is obligated to repurchase the item under a put option held by the customer for an amount less than the original selling price and the holder of the put option has a significant economic incentive to exercise the put.

If the arrangement is accounted for as a lease, the lease payments used to determine 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 the entity provides to the purchaser as of the first exercise date of the guarantee.

We believe that entities should view a guaranteed resale amount (residual value) on a net present value basis when they determine the classification of the transaction.

For example, Company X sells a computer for $100 (i.e., fair value) and agrees to reacquire the computer in five years for $10 through a put option held by the customer. In accordance with ASC 606-10-55-72, the arrangement is accounted for as a lease because Company X is obligated to repurchase the computer for an amount that is less than the original selling price and the entity determines that the holder of the put option has a significant economic incentive to exercise the put. The present value of the $10 repurchase obligation is $6. As a result, the transaction is classified as a sales-type lease because the proceeds of the sale ($100) less the present value of the repurchase obligation ($6) equals or exceeds substantially all of the equipment’s fair value. That is because the FASB said in ASC 842-10-55-2 that “one reasonable approach” would be to conclude that “[n]inety percent or more of the fair value of the underlying asset amounts to substantially all the fair value of the underlying asset.” Refer to section 3.2, *Criteria for lease classification — lessors*.

Refer to section 5.7.7, *Sales of equipment with guaranteed minimum resale amount*, for further discussion on these types of transactions.

## Discount rates used to determine lease classification

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

### Discount rates used to determine lease classification — lessees

For lessees, the discount rate used to evaluate the “substantially all” criterion is the “rate implicit in the lease” or the lessee’s incremental borrowing rate (or for a lessee that is not a PBE, the risk-free rate if the lessee has made the risk-free rate election for that class of underlying asset), if the rate implicit in the lease cannot be readily determined. Refer to section 2.5, *Discount rates*.

### Discount rates used to determine lease classification — lessors

Sales-type lease classification test

The discount rate used to evaluate the “substantially all” criterion in the sales-type lease classification test (as described in ASC 842-10-25-2(d)) is the rate implicit in the lease (refer to section 2.5, *Discount rates*). However, a lessor assumes that none of its initial direct costs (refer to section 2.6, *Initial direct costs*) will be deferred (i.e., initial direct costs are excluded from the calculation of the rate implicit in the lease) if, at the commencement date, the fair value (refer to section 2.8, *Fair value*) of the underlying asset is different from its carrying amount. If the fair value of the underlying asset is the same as its carrying amount at lease commencement, a lessor includes initial direct costs in the calculation of the rate implicit in the lease.

Direct financing lease classification test

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

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

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

## Lease classification considerations

### Transfer of ownership

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

### Evaluating purchase options

A lease is classified as a finance lease by a lessee and a sales-type lease by a lessor if the lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise. The term “reasonably certain” is generally considered to be a high threshold (refer to section 2.3.1, *Lease term*). Purchase options should be assessed in the same way as options to extend the lease term or terminate the lease. Factors that could create an economic incentive for the lessee to exercise the purchase option might include a bargain purchase option (e.g., a fixed-price purchase option priced significantly below the expected fair value of the underlying asset) or contractual or economic penalties. Refer to section 2.3.5, *Evaluating lease term and purchase options.*

### Evaluating ‘major part,’ ‘substantially all’ and ‘at or near the end’

The terms “major part,” “substantially all” and “at or near the end” are not defined in ASC 842. However, ASC 842 includes implementation guidance that states that one reasonable approach to lease classification is to conclude that 75% or greater is a “major part” of the remaining economic life (refer to section 2.7, *Economic life*) *of* an underlying asset (refer to section 2.2, *Commencement date of the lease*), 90% or greater is “substantially all” the fair value (as defined in ASC 820, or in ASC 842 for certain lessors that are not manufacturers or dealers, as applicable, refer to section 2.8, *Fair value*) of the underlying asset and a commencement date that falls within the last 25% of the total economic life of the underlying asset is “at or near the end” of the total economic life of the underlying asset (refer to section 2.7, *Economic life*). We believe an entity should establish accounting policies for the thresholds it uses to determine lease classification, have a reasonable basis for those policies if they differ from the “reasonable approach” articulated in the standard and apply those policies consistently. Policies that differ from the “reasonable approach” discussed in ASC 842 may be challenged.

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

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

### Residual value guarantees included in the lease classification test

A lessee is required to include the full amount of a residual value guarantee (or an allocated portion of a portfolio-based residual value guarantee in certain circumstances — refer to section 2.10.3, *Residual value guarantees of a group of assets — lessees*) it provides to a lessor (i.e., its maximum obligation) in its evaluation of the “substantially all” criterion of the lease classification test (i.e., in its evaluation of

ASC 842-10-25-2(d)). A lessor is also required to include the full amount of such a residual value guarantee provided by a lessee in its evaluation of whether a lease is a sales-type lease (excluding certain portfolio- based residual value guarantees — refer to section 2.10.4, Residual value guarantees of a group of assets — *lessors*). However, if a lease does not qualify as a sales-type lease, a lessor includes the full amounts

of such residual value guarantees provided by both lessees and any other third party unrelated to the lessor in its evaluation of the “substantially all” criterion of the lease classification test to determine whether a lease is a direct financing lease (i.e., in its evaluation of ASC 842-10-25-3(b)(1)).

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

Refer to section 2.4, *Lease payments*. Lessors would account for receipt of payment under a residual value guarantee in income when it is earned.

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

### Fair value of the underlying asset

In some cases, it may not be practicable for an entity to determine the fair value (refer to section 2.8, *Fair value*) of an underlying asset without undue cost or effort. For example, this may be the case when the underlying asset is part of a larger asset. If a reasonable estimate of fair value cannot be made without undue cost or effort, lessees and lessors will not evaluate the “substantially all” classification criterion described in sections 3.1, *Criteria for lease classification — lessees*, and 3.2, *Criteria for lease classification — lessors*. Instead, lease classification will be based on the remaining classification criteria described in section 3.1, *Criteria for lease classification — lessees*.

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

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

##### Effect of investment tax credits on lease classification

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

### Alternative use criterion

A lease is classified as a finance lease by a lessee and a sales-type lease by a lessor if the underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term. The FASB indicated in the Basis for Conclusions (BC 71(e)) of ASU 2016-02 that lessors generally would lease specialized assets that have no alternative use to them at the end of the lease term

under terms that would transfer substantially all the benefits (and risks) of the asset to the lessee. That is, when this criterion is met, it is likely that one of the other criteria described in section 3.1, *Criteria for lease classification — lessees*, will also be met. An exception could be when a significant amount of anticipated lease payments is in the form of variable lease payments that do not depend on an index or rate.

When assessing whether an underlying asset has an alternative use to the lessor at the end of the lease term, lessees and lessors should consider the effects of substantive contractual restrictions and practical limitations on the lessor’s ability to readily direct that asset for another use (e.g., sell it, re-lease it). A practical limitation exists if the lessor would incur significant economic losses to repurpose the underlying asset for another use (e.g., if the lessor either would incur significant costs to rework the asset or would only be able to sell or re-lease the asset at a significant loss).

### Lessee indemnifications for environmental contamination

A provision that requires lessee indemnifications for preexisting environmental contamination or environmental contamination caused by the lessee during its use of the underlying asset over the term of the lease does not affect classification of the lease. Indemnities for preexisting environmental contamination are accounted for under ASC 460, whereas indemnities for contamination caused by the lessee during the lease term are excluded from the requirements of ASC 460 as they represent a guarantee of the lessee’s own performance. Contamination caused by the lessee during the lease term and related obligations are accounted for under ASC 410-30, *Environmental obligations*.

### Leases of government-owned facilities

Arrangements for the use of property owned by a governmental unit may meet the definition of a service concession arrangement that is within the scope of ASC 853, *Service Concession Arrangements* (refer to section 1.8, *Service concession arrangements*). If the arrangement is not within the scope of ASC 853 and is a lease (or contains a lease), the lease is classified as an operating lease when it meets all of the criteria in ASC 842-10-55-13.

### Classification of subleases

Lessees often enter into arrangements to sublease an underlying asset to a third party while the original lease contract is in effect. In these arrangements, one party acts as both the lessee and lessor of the same underlying asset. The original lease is often referred to as a head lease, the original lessee is often referred to as a sublessor and the ultimate lessee is often referred to as the sublessee.

Under ASC 842, a sublessor assesses sublease classification independently of the classification assessment that it makes as the lessee of the same asset. A sublessor considers the lease classification criteria for lessors, discussed in section 3.2, *Criteria for lease classification — lessors*, with reference to the underlying asset (i.e., the item of property, plant or equipment that is the subject of the lease) when classifying a sublease. A sublessee assesses classification of the sublease in the same manner as any other lease using the criteria discussed in section 3.1, *Criteria for lease classification — lessees*. Refer to section 6, *Subleases,* for further discussion of the accounting for subleases by sublessors and sublessees.

### Example — lessee classification (added July 2024)

|  |
| --- |
| **Illustration 3-1: Ground lease classification** |
| A real estate entity (Lessee) enters into a ground lease of land in New York City with a term of 99 years. Lessee will construct and operate an office building on the land and will lease office space to tenants.  There is no transfer of ownership or option to purchase the land at the end of the lease term. There is no residual value guaranteed by Lessee at the end of the lease term. The present value of the lease payments is $95 million. The fair market value (FMV) of the land is $100 million.  *Analysis*  The arrangement meets the definition of a lease. Lessee then assesses the classification criteria in ASC 842-10-25-2:   * The lease does not transfer ownership of the land to Lessee at the end of the lease term. * The lease does not grant Lessee an option to purchase the land. * The lease term (99 years) is not for the major part of the remaining economic life of the land because land has an indefinite life. * The present value of the sum of the lease payments ($95 million) exceeds substantially all of the FMV of the land ($100 million). * The land is not of such a specialized nature that it is expected to have no alternative use at the end of the lease term.   However, because the present value of the sum of the lease payments equals or exceeds substantially all of the fair value of the underlying asset, Lessee concludes that the lease is a finance lease. |

## Reassessment of lease classification

Lessees and lessors are required to reassess lease classification as noted in the following table:

|  |  |  |
| --- | --- | --- |
|  | **Reassess lease classification?** | |
| **Event** | **Lessee** | **Lessor** |
| Lease modification (i.e., a change to the terms and conditions of the contract that results in a change in the scope of or the consideration for the lease) that is not accounted for as a separate contract | Yes1 | Yes1 |
| Change in assessment of lease term | Yes | N/A2 |
| Change in assessment of whether lessee is reasonably certain to exercise an option to purchase the underlying asset (refer to section 2.3.6, *Reassessment of the lease term and purchase options*) | Yes | N/A2 |

1 Refer to section 4.6, *Lease modifications*, and section 5.6, *Lease modifications*, for a discussion of which modifications are accounted for as separate contracts for lessees and lessors, respectively.

2 When a lessee exercises an option to extend or terminate the lease or purchase the underlying asset and the exercise of the option is inconsistent with the existing lease term determination, the lessor accounts for the exercise in the same manner as a lease modification (refer to section 5.6, *Lease modifications*, and section 5.6.1, *Summary of the accounting for lease modifications — lessors*, for further discussion).

Lessees and lessors reassess lease classification as of the effective date of a modification to a contract (i.e., an agreement between two or more parties that creates enforceable rights and obligations) that is not accounted for as a separate contract, using the modified terms and conditions and the facts and circumstances as of that date, including:

* The remaining economic life of the underlying asset on that date
* The fair value of the underlying asset on that date
* The discount rate for the lease on that date
* The remeasurement and reallocation of the remaining consideration in the contract on that date

When there is 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, the lessee would reassess lease classification based on the facts and circumstances as of the date that the reassessment is required.

If a modification to a contract is accounted for as a separate contract that contains a lease, that separate lease is classified in the same manner as any new lease. Refer to sections 3.1, *Criteria for lease classification — lessees*, and 3.2, *Criteria for lease classification — lessors*.

### Summary of lease reassessment and remeasurement requirements

This table summarizes lessee and lessor reassessment and remeasurement requirements under ASC 842.

|  |  |  |
| --- | --- | --- |
|  | **Lessees** | **Lessors** |
| Assessment of whether an arrangement contains a lease | Reassess whether a contract is or contains a lease only if the terms and conditions of the contract are changed.  (ASC 842-10-15-6 and section 1.3,  *Reassessment of the contract*) | Reassess whether a contract is or contains a lease only if the terms and conditions of the contract are changed.  (ASC 842-10-15-6 and section 1.3,  *Reassessment of the contract)* |
| Allocation of consideration in the contract between lease and non-lease components | Remeasure and reallocate1 the consideration in the contract upon either of the following:   * A remeasurement of the lease liability (section 4.5, *Remeasurement of lease liabilities and right-of-use assets — operating and finance leases*) * The effective date of a contract modification that is not accounted for as a separate contract (section 4.6.2, *Determining whether a lease modification is accounted for as a separate contract*)   (ASC 842-10-15-36 and section 1.4.3.3,  *Reassessment: determining and allocating the consideration in the contract* — *lessees*) | Remeasure and reallocate2 the remaining consideration in the contract upon a contract modification that is not accounted for as a separate contract (section 5.6.2, Determining whether a lease modification is accounted for as a separate contract).  If the consideration in the contract changes, allocate those changes in accordance with the requirements in ASC 606-10-32-42 through 32-45.  (ASC 842-10-15-41 through 15-42 and  section 1.4.4.5, *Reassessment: determining and allocating the consideration in the contract — lessors*) |
| Assessment of lease term and purchase options | Reassess upon any of the following:   * There is a significant event or change in circumstances within the lessee’s control that directly affects whether the lessee is reasonably certain to (1) extend the lease term, (2) not terminate the lease or   (3) purchase the underlying asset. A change in market-based factors should not, in isolation, trigger a reassessment.   * There is an event that is written into the contract that obliges the lessee to exercise or not to exercise an option to extend or terminate the lease. * The lessee elects to exercise an option in the lease (i.e., extension, termination or purchase) even though it had previously determined that it was not reasonably certain to do so. * The lessee elects not to exercise an option in the lease (i.e., extension, termination or purchase) even though it had previously determined that it was reasonably certain to do so.   (ASC 842-10-35-1 and section 2.3.6.1, *Reassessment of the lease term and purchase options — lessees*) | Reassess when the lease is modified, and the modified lease is not accounted for as a separate contract (section 5.6.2, *Determining whether a lease modification is accounted for as a separate contract*).  When a lessee exercises an option to extend or terminate the lease or purchase the underlying asset and the exercise of the option is inconsistent with the existing lease term determination, the lessor accounts for the exercise of that option in the same manner as a lease modification (refer to section 5.6, *Lease modifications*, and section 5.6.1, *Summary of the accounting for lease modifications — lessors*).  (ASC 842-10-35-3 and section 2.3.6.2, *Reassessment of the lease term and purchase options — lessors*) |

|  |  |  |
| --- | --- | --- |
|  | **Lessees** | **Lessors** |
| Measurement of lease payments (including variable lease payments that depend on an index or rate, the exercise price of a purchase option and, for lessees only, amounts it is probable they will owe under residual value guarantees)  Also, refer to sections 2.10.3, *Residual value guarantee of a group of assets — lessees*, and 2.10.4, *Residual value guarantee of a group of assets — lessors* | Remeasure upon any of the following:   * A lease modification that is not accounted for as a separate contract (section 4.6.2, *Determining whether a lease modification is accounted for as a separate contract*) * A resolution of a contingency that results in some or all of the lease payments that were previously determined to be variable meeting the definition of lease payments * A change in the lease term (section 2.3.6.1, *Reassessment of the lease term and purchase options — lessees)* * A change in the assessment of whether a lessee is reasonably certain to exercise an option in the lease to purchase the underlying asset (section 2.3.6.1, *Reassessment of the lease term and purchase options — lessees)* * A change in amounts it is probable that a lessee will owe under residual value guarantees   (ASC 842-10-35-4 through 35-5 and section 2.4.11.1, *Subsequent remeasurement of lease payments — lessees*) | Remeasure upon a modification that is not accounted for as a separate contract (section 5.6.2, *Determining whether a lease modification is accounted for as a separate contract*)*.*  (ASC 842-10-35-6 and section 2.4.11.2,  *Subsequent remeasurement of lease payments — lessors*) |
| Assessment of lease classification3 | Reassess upon any of the following:   * A modification that is not accounted for as a separate contract (section 4.6.2, *Determining whether a lease modification is accounted for as a separate contract*) * A change to the lease term or assessment of whether a lessee is reasonably certain to exercise an option in the lease to purchase the underlying asset (section 2.3.6.1, *Reassessment of the lease term and purchase options — lessees*)   (ASC 842-10-25-1 and section 3.5,  *Reassessment of lease classification*) | Reassess upon a modification that is not accounted for as a separate contract (section 5.6.2, *Determining whether a lease modification is accounted for as a separate contract*).  (ASC 842-10-25-1 and section 3.5,  *Reassessment of lease classification*) |
| Assessment of the discount rate | Reassess upon any of the following:   * A change in the lease term or the assessment of whether a lessee is reasonably certain to exercise an option to purchase the underlying asset if the discount rate for the lease liability does not already reflect the lessee’s option in the lease to extend or terminate the lease or to purchase the underlying asset * A modification that is not accounted for as a separate contract (section 4.6.2, *Determining whether a lease modification is accounted for as a separate contract*)   (ASC 842-20-35-5, section 2.5.3.2,  *Reassessment of the discount rate — lessees,* and section 4.5, *Remeasurement of lease liabilities and right-of-use assets — operating and finance leases*) | Reassess, for purposes of lease classification, upon a modification that is not accounted for as a separate contract.  (ASC 842-10-25-9 and section 3.5,  *Reassessment of lease classification*)  The discount rate used to account for the modified lease depends on the classification of the lease before and after the lease modification.  (ASC 842-10-25-15 through 25-17,  section 2.5.3.1, *Reassessment of the discount rate — lessors*, and section 5.6.3, *Lessor accounting for a modification that is not accounted for as a separate contract*) |

|  |  |  |
| --- | --- | --- |
|  | **Lessees** | **Lessors** |
| Assessment of collectibility | Not applicable | If collectibility is probable at the commencement date for a sales-type or a direct financing lease, a lessor does not reassess collectibility for purposes of lease classification. Changes in collectibility are accounted for in accordance with the impairment guidance applicable to the net investment in the lease.  (ASC 842-30-25-6, section 5.2.1.1, *Initial recognition and measurement when collectibility is probable at lease commencement — sales-type leases*, for sales-type leases, and section 5.3.1, *Initial recognition and measurement — direct financing leases*, for direct financing leases)  If collectibility is not probable at the commencement date for a sales-type lease, a lessor continually reassesses collectibility until it becomes probable.  (ASC 842-30-25-3 and section 5.2.1.2, *Initial recognition and measurement when collectibility is not probable at lease commencement — sales-type leases*)  If collectibility is not probable at the commencement date, a lease that would otherwise be classified as a direct financing lease is instead classified and accounted for as an operating lease. The classification of such a lease is not changed based upon a subsequent evaluation of collectibility.  For an operating lease, a lessor continually reassesses collectibility.  (ASC 842-30-25-13 and section 5.4,  *Operating leases*) |

**Note:** Refer to section 4.6, *Lease modifications*, and section 5.6, *Lease modifications*, for further details on accounting for lease modifications by lessees and lessors, respectively.

1 ASC 842 provides a practical expedient that permits lessees to make an accounting policy election (by class of underlying asset) to account for each separate lease component of a contract and its associated non-lease components as a single lease component. Lessees that elect this practical expedient do not reallocate the remaining consideration in the contract to non-lease components upon the events discussed above. Refer to section 1.4.2.3, *Practical expedient to not separate lease and non-lease components — lessees*.

2 ASC 842 provides a practical expedient that permits lessors to make an accounting policy election (by class of underlying asset) to account for each separate lease component of a contract and its associated non-lease components as a single component if certain criteria are met. Refer to section 1.4.2.4, *Practical expedient to not separate lease and non-lease components — lessors*.

3 For leases that were classified as leveraged leases in accordance with ASC 840, and for which the commencement date is before the effective date of ASU 2016-02, a lessor applies the requirements in ASC 842-50 (i.e., the leveraged lease accounting guidance). If a leveraged lease is modified on or after the effective date, it is accounted for as a new lease as of the effective date of the modification in accordance with ASC 842-10 and 842-30 (i.e., it will no longer be accounted for as a leveraged lease) (ASC 842-10-65-1(z)).

# Lessee accounting

Under ASC 842, lessees are required to recognize an ROU asset and lease liability on the balance sheet for most leases. The initial measurement of the lease liability and ROU asset on the commencement date is the same for both operating and finance leases. The difference in accounting for an operating lease and finance lease is in the subsequent measurement. The income statement presentation and expense recognition pattern for finance leases results in separate interest and amortization expense with higher periodic expense in the earlier periods of a lease. For operating leases, the income statement presentation and expense recognition pattern results in a single lease cost generally recognized on a straight-line basis.

The following chart provides an overview of the accounting for operating and finance leases by lessees, which is discussed in further detail in this section:

|  |  |  |
| --- | --- | --- |
|  | **Operating leases** | **Finance leases** |
| Initial recognition and measurement | Initially measure the ROU asset1 and lease liability at the present value of the lease payments to be made over the lease term | |
| Subsequent measurement — lease liability3 | Measure the lease liability at the present value of remaining lease payments using the discount rate determined at lease commencement2 | Accrete the lease liability based on the interest method using the discount rate determined at lease commencement2 and reduce the lease liability by the payments made |
| Subsequent measurement — ROU asset | Measure the ROU asset at the amount of the remeasured lease liability, adjusted for the remaining balance of any lease incentives received, any cumulative prepaid or accrued rents (i.e., uneven rent payments), any unamortized IDCs and any impairment of the ROU asset | Amortize the ROU asset, generally on a straight-line basis, over the shorter of the lease term or the useful life of the ROU asset, and record any impairment of the ROU asset |
| Income statement effect | Generally, straight-line expense | Generally, “front-loaded” expense |

1 Initial measurement of the ROU asset also includes the lessee’s IDCs and prepayments made to the lessor at or before the commencement date, less lease incentives received from the lessor.

2 As long as the discount rate has not been updated as a result of a reassessment event.

3 Although the subsequent measurement of operating lease liabilities and finance lease liabilities is described differently, the calculation results in the same amount each period.

## Initial recognition

At the commencement date of a lease, a lessee recognizes a liability to make lease payments (i.e., the lease liability) and an asset representing the right to use the underlying asset during the lease term (i.e., the right-of-use asset).

The initial recognition of the right-of-use asset and the lease liability is the same for operating leases and finance leases, as is the subsequent measurement of the lease liability. However, the subsequent measurement of the right-of-use asset for operating leases and finance leases differs under ASC 842 (refer to section 4.2.2.2, *Subsequent measurement of right-of-use assets — operating leases,* and 4.3.2.2, *Subsequent measurement of right-of-use assets — finance leases*).

### Short-term leases (updated July 2024)

Lessees can make an accounting policy election (by class of underlying asset to which the right of use relates) to not record leases on the balance sheet that meet ASC 842’s definition of a short-term lease (i.e., the short-term lease election). This accounting policy election does not apply to lessors. A short-term lease is defined as a lease that, at the commencement date, has a lease term of 12 months or less and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise. The short-term lease election can only be made at the commencement date (refer to section 2.2, *Commencement date of the lease*, for discussion of the commencement date).

ASC 842 does not address how an entity should identify a class of underlying asset. Entities may want to consider the following:

* ASC 360-10-50 also requires disclosures of ”balances of major classes of depreciable assets, by nature or function.”
* The ASC Master Glossary defines an intangible asset class as “a group of intangible assets that are

similar, either by their nature or by their use in the operations of an entity.”

A lessee that makes this accounting policy election does not recognize a lease liability or right-of-use asset on its balance sheet. Instead, the lessee recognizes lease payments on a straight-line basis over the lease term and variable lease payments that do not depend on an index or rate in the period in which the achievement of the specified target that triggers the variable lease payments becomes probable. Any previously recognized variable lease cost is reversed if it becomes probable that the specified target will no longer be met. Refer to sections 2.4.10, *Amounts not included in lease payments*, and 2.9.1, *Lessee accounting for variable lease payments*, for further discussion of variable lease payments that do not depend on an index or rate and the accounting for their reversal.

When determining whether a lease qualifies as a short-term lease, a lessee evaluates the lease term and the purchase option in the same manner as all other leases. Refer to section 2.3, *Lease term and purchase options.* That is, the lease term includes the noncancelable term of the lease and all of the following:

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

A lease that qualifies as a short-term lease at the commencement date no longer meets the definition of a short-term lease when there is a change in a lessee’s assessment of either:

* The lease term so that, after the change, the remaining lease term extends more than 12 months from the end of the previously determined lease term
* Whether it is reasonably certain to exercise an option to purchase the underlying asset

When the lease no longer meets the definition of a short-term lease, a lessee that is applying the short- term lease election must apply the recognition and measurement guidance for all other leases as if the date of the change in circumstances is the commencement date. Additionally, if at lease commencement a lessee determines that the lease term is longer than 12 months, it cannot elect the short-term lease election if the lease is subsequently reassessed (refer to section 2.3.6, *Reassessment of the lease term and purchase options*) and has a lease term less than 12 months. Likewise, a lessee cannot elect the short-term lease election if, as a result of a lease modification that is not accounted for as a separate contract (refer to section 4.6.2, *Determining whether a lease modification is accounted for as a separate contract*), the lease term is modified to be less than 12 months.

The short-term lease election is intended to reduce the cost and complexity of applying ASC 842. However, a lessee that makes the election must make certain quantitative and qualitative disclosures about short- term leases. Refer to section 4.10, *Disclosure*.

Once a lessee establishes a policy for a class of underlying assets, all future short-term leases for that class are required to be accounted for in accordance with the lessee’s policy. A lessee evaluates any potential change in its accounting policy in accordance with the guidance in ASC 250, *Accounting Changes and Error Corrections*.

|  |
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| **Illustration 4-1: Short-term lease** |
| **Scenario A**  A lessee enters into a lease with a nine-month noncancelable term with an option to extend the lease for four months. The lease does not include a purchase option. At the lease commencement date, the lessee concludes that it is reasonably certain to exercise the extension option because the monthly lease payments during the extension period are significantly below market rates. The lessee has an established accounting policy to use the short-term lease election for the class of underlying asset subject to this lease.  *Analysis*: The lease term is greater than 12 months (i.e., 13 months). Therefore, the lessee may not account for the lease as a short-term lease.  **Scenario B**  Assume the same facts as in Scenario A except, at the lease commencement date, the lessee concludes that it is not reasonably certain to exercise the extension option because the monthly lease payments during the optional extension period are what the lessee expects to be market rates, and there are no other factors that would make exercise of the renewal option reasonably certain.  *Analysis*: The lease term is 12 months or less (i.e., nine months). Therefore, the lessee accounts for the lease under the short-term lease election (i.e., it recognizes lease payments on a straight-line basis over the lease term and does not recognize a lease liability or right-of-use asset on its balance sheet). |

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| **Illustration 4-2: Noncancelable lease term of nine months with a four-month renewal option (assume no purchase option)** |
| Scenario A: Exercise of option is reasonably certain = **not** short-term lease  **Nine months Four months**  Scenario B: Exercise of option is **not** reasonably certain = short-term lease  **Nine months Four months**  Noncancelable lease term Optional renewal period |

Question 4-1 Do leases that give an airline the right to use a gate at an airport for longer than a year, but only at specified times of the day, qualify for the short-term lease election? (added July 2024)

Airport gate leases may qualify for the short-term lease election because the lease term is determined based on the nonconsecutive periods of use. For example, assume an airline leases a terminal gate for two years with no renewal options but can only use the gate between 6:00 p.m. and midnight (i.e., for six hours, or 25% of the time, each day). During the remaining hours of each day, another party (e.g., the airport) controls the right to use the terminal gate. In this example, the lease term is approximately 183 days (i.e., 25% of each day X 365 days per year X 2 years). Because the lease term is 12 months or less, the lease could qualify for the short-term lease election.

## Operating leases

### Initial measurement — operating leases

##### Initial measurement of lease liabilities — operating leases

At the commencement date (refer to section 2.2, *Commencement date of the lease*), a lessee initially measures the lease liability at the present value of the lease payments to be made over the lease term. Lessees apply the concepts previously described in section 1, *Scope and scope exceptions*, and section 2, *Key concepts*, to identify the lease components and to determine the lease term, lease payments and discount rate as of the commencement date of the lease.

The diagram below illustrates the inputs needed to initially calculate the lease liability:

Present value using the discount rate determined on the commencement date

Lease payments to be made over the lease term1

Lease liability

1 Lease incentives that are payable to the lessee on the commencement date are deducted from lease payments (i.e., they reduce the lease liability). Refer to section 2.4.1.2, *Lease incentives*.

##### Initial measurement of right-of-use assets — operating leases

A lessee initially measures the right-of-use asset at cost, which consists of all of the following:

* The amount of the initial measurement of the lease liability
* Any lease payments made to the lessor at or before the commencement date, less any lease incentives received (refer to section 2.4.1.2, *Lease incentives*)
* Any initial direct costs incurred by the lessee (refer to section 2.6, *Initial direct costs*) The diagram below illustrates the inputs needed to initially calculate the ROU asset:

Lease liability

Lease prepayments

Initial direct costs

Lease incentives received

ROU asset

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

### Subsequent measurement — operating leases (updated July 2024)

The following graphic summarizes the subsequent measurement of operating leases by lessees.

**Step 1:**

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4 )

**Step 2:** Amortize IDCs (see section 4.2.2.2)

.2.3 and 4.2.2.2

**Step 3:**

Adjust the lease liability

(see section 4.2.2.1)

##### Subsequent measurement of lease liabilities — operating leases

After lease commencement, a lessee measures the lease liability for an operating lease at the present value of the remaining lease payments using the discount rate determined at lease commencement, as long as the discount rate has not been updated as a result of a reassessment event (refer to section 2.5.3, *Reassessment of the discount rate*).

##### Subsequent measurement of right-of-use assets — operating leases

A lessee subsequently measures the right-of-use asset for an operating lease at the amount of the remeasured lease liability (i.e., the present value of the remaining lease payments), adjusted for the remaining balance of any lease incentives received, any cumulative prepaid or accrued rent if the lease payments are uneven throughout the lease term and any unamortized initial direct costs. If the right-of-use asset becomes impaired, refer to section 4.2.3, *Expense recognition — operating leases*.

The FASB indicated in the Basis for Conclusions (BC 253) of ASU 2016-02 that the carrying amount of the right-of-use asset for an operating lease is intended to approximate the present value of the remaining benefits to the lessee at each measurement date. Therefore, the subsequent measurement of the right-of-use asset reflects the subsequent measurement of the lease liability (i.e., the present value of the remaining lease payments), adjusted for the effect of uneven lease payments.

ASC 842 requires the right-of-use asset for an operating lease to be subsequently measured using the lease liability balance, adjusted for the effect of uneven lease payments, assuming there is no impairment. Therefore, the right-of-use asset is effectively a “plug” necessary to achieve straight-line expense recognition for operating leases.

ASC 842 does not address the accounting for lease incentives that are contingently receivable by the lessee at the lease commencement date (i.e., lease incentives that are not received or receivable until the occurrence of an event subsequent to lease commencement). Examples include reimbursements for moving costs or leasehold improvements that become receivable by the lessee when the lessee incurs these costs. Refer to section 2.4.1.2, *Lease incentives,* for a discussion of lease incentives, including the timing of recognition of contingently receivable incentives.

### Expense recognition — operating leases

When subsequently accounting for an operating lease, lessees recognize the following:

**A single lease cost**

**Variable lease payments that are not included in the lease liability (i.e., variable lease payments that do not depend on**

**an index or rate)**

**Changes to variable lease payments that depend on an index or rate**

**Impairment of the right-of-use asset (refer to section 4.2.5,**

***Impairment of the right-of-use assets in operating leases*)**

Operating leases

To clarify, a lessee’s lease cost 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 applicable guidance, such as ASC 330.

Single lease cost

After lease commencement, a lessee recognizes a single lease cost for an operating lease on a straight- line basis. This is consistent with the concept of the lessee paying to use the asset during the lease term rather than paying to finance the acquisition of the underlying asset in a finance lease. The single lease cost for an operating lease differs from the cost for a finance lease (i.e., a lessee separately recognizes interest on the finance lease liability and amortization on the finance lease right-of-use asset).

Absent an impairment of the right-of-use asset (see section 4.2.5.4, *Accounting for an operating lease after an impairment of a right-of-use asset (single lease cost)*), the single lease cost is calculated so that the remaining cost of the lease is allocated over the remaining lease term on straight-line basis unless another systematic and rational basis is more representative of the pattern in which benefit is expected to be derived from the right to use the underlying asset.

The remaining cost of the lease is calculated as:

* Total lease payments (including those previously paid and not yet paid)
* Plus total lessee initial direct costs (attributable to the lease)
* Minus the periodic lease cost recognized in prior periods

Total lease payments are adjusted to reflect changes that arise from a lease modification (i.e., a change to the terms and conditions of the contract that results in a change in the scope of or consideration for the lease) or the remeasurement of the lease liability not recognized in profit or loss at the date of remeasurement (e.g., a change in lease term). Refer to section 4.5, *Remeasurement of lease liabilities and right-of-use assets — operating and finance leases*.

Pattern of benefit from use of the underlying asset

Operating lease agreements may specify scheduled rent increases over the lease term (refer to section 2.3, *Lease term and purchase options*) or periods during the lease term for which rent payments

are not required (i.e., rent holidays). Uneven rental payments (increases, decreases or holidays) are often designed to provide an inducement for the lessee, to reflect the anticipated effects of inflation, to ease the lessee’s near-term cash flow requirements or to acknowledge the time value of money. For operating leases that include uneven rental payments, rental expense should be recognized by a lessee on a straight-line basis over the lease term unless another systematic and rational allocation basis is more representative of the time pattern in which a benefit is expected to be derived from the right to use the underlying asset, unless the right-of-use asset becomes impaired (refer to section 4.2.5, *Impairment of right-of-use assets in operating leases*). Using factors such as the time value of money or anticipated inflation is inappropriate because these factors do not relate to the physical usage of the underlying asset.

Lease agreements may include scheduled rent increases designed to accommodate the lessee’s projected physical use of the underlying asset. For example, rents may escalate in contemplation of the lessee’s physical use of the underlying asset even though the lessee takes possession of or controls the physical use of the underlying asset at commencement.

It is important to note the standard emphasizes the benefit from the “right to use” as opposed to how the lessee is expected to use the underlying asset. If rents escalate in contemplation of the lessee’s physical use of the underlying asset but the lessee takes possession of or controls the physical use of the underlying asset at the beginning of the lease term, all rental payments, including the escalated rents, should be recognized as rental expense on a straight-line basis starting with the beginning of the lease term (i.e., rent expense is not affected by the extent to which the lessee uses the asset).

The application of the guidance above to an operating lease with uneven rental payments that are not representative of the pattern in which benefit is expected to be derived from the right to use the underlying asset results in prepaid or accrued rentals. If the lessee purchases the underlying asset prior to the expiration of the lease term, any prepaid or accrued rentals should be included in the determination of the purchase price of the asset (refer to section 4.8.2, *Purchase of an underlying asset during the lease term,* for further discussion). If the lease agreement is extended, lessees should apply the guidance in section 4.6, *Lease modifications.*

Variable lease payments

After the commencement date, lessees also recognize as part of lease-related cost any variable lease payments not included in the operating lease liability in the period in which the achievement of the specified target that triggers the variable lease payments becomes probable. Any previously recognized variable lease costs are reversed if it becomes probable that the specified target will no longer be met. Refer to section 2.4.10, *Amounts not included in lease payments,* for a discussion of variable leases payments that do not depend on an index or rate.

Impairment of the right-of-use asset

If a lessee determines that a right-of-use asset is impaired, it recognizes an impairment loss and measures the right-of-use asset at its carrying amount immediately after the impairment. Following an impairment, the single lease cost is calculated in the manner described in section 4.2.5, *Impairment of right-of-use assets in operating leases*.

### Example — lessee accounting for an operating lease

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| **Illustration 4-3: Lessee accounting for an operating lease** |
| Entity L (lessee) makes a payment of $5,000 to an existing tenant to obtain a lease and enters into a three-year lease of the same office space that it concludes is an operating lease. The lease commences at the beginning of Year 1. Entity L agrees to make the following annual payments at the end of each year: $10,000 in Year 1, $12,000 in Year 2 and $14,000 in Year 3. Entity L concludes that the  $5,000 payment to the former tenant qualifies as an initial direct cost (IDC). For simplicity, there are no purchase options, payments to the lessor before the lease commencement date, variable payments based on an index or rate, or lease incentives from the lessor. The initial measurement of the right-of- use asset and lease liability is $33,000 using a discount rate of 4.235%. Entity L uses its incremental borrowing rate because the rate implicit in the lease cannot be readily determined. Entity L calculates that the annual straight-line lease expense is $12,000 per year [($10,000 + $12,000 + $14,000) ÷ 3]. |

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | **Initial** | **Year 1** | **Year 2** | **Year 3** |
| Cash lease payments: |  | $ 10,000 | $ 12,000 | $ 14,000 |
| *Income statement:* |  |  |  |  |
| Periodic lease expense (straight-line) |  | (12,000) | (12,000) | (12,000) |
| Amortization of IDC |  | (1,667) | (1,667) | (1,666) |
| Total lease expense |  | $ (13,667) | $ (13,667) | $ (13,666) |
| (Accrued)/prepaid rent for period |  | $ (2,000) | $ — | $ 2,000 |
| *Balance sheet:* |  |  |  |  |
| Lease liability | $ (33,000) | $ (24,398) | $ (13,431) | $ — |
| Right-of-use asset |  |  |  |  |
| Lease liability | $ 33,000 | $ 24,398 | $ 13,431 | $ — |
| Unamortized IDC | 5,000 | 3,333 | 1,666 | — |
| (Accrued)/prepaid rent (cumulative) | — | (2,000) | (2,000) | — |
|  | $ 38,000 | $ 25,731 | $ 13,097 | $ — |

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| *Analysis*: At lease commencement, Entity L would recognize the right-of-use asset and lease liability:  Right-of-use asset $ 38,000  Lease liability $ 33,000  Cash 5,000  *To initially recognize the right-of-use asset, lease liability and the payment that qualifies as an IDC.*  The following journal entries would be recorded in Year 1:  Lease expense $ 12,000  Right-of-use asset (accrued rent) $ 2,000 Cash 10,000  *To record lease expense and adjust the right-of-use asset for the difference between cash paid and straight-line lease expense (i.e., accrued rent).*  Lease expense (amortization of IDC) $ 1,667  Right-of-use asset (amortization of IDC) $ 1,667  *To record amortization of the IDC ($5,000 ÷ 3 years = $1,667).*  Lease liability $ 8,602  Right-of-use asset $ 8,602  *To adjust the lease liability to the present value of the remaining lease payments with an offset to the right-of-use asset. The adjustment of $8,602 is calculated as the initially recognized lease liability ($33,000) less the present value of remaining lease payments ($24,398) at the end of Year 1.*  A summary of the lease contract’s accounting (assuming no changes due to reassessment, lease  modification or impairment) is as follows:  Immaterial differences may arise in the recomputation of amounts in the example above due to rounding.  Refer to section 4.3.5, *Example — lessee accounting for a finance lease*, for a table that illustrates the similarities and differences in the accounting for an operating lease and a finance lease. |

### Impairment of right-of-use assets in operating leases (updated August 2023)

A lessee’s right-of-use asset in an operating or finance lease is subject to the impairment guidance in ASC 360-10 (for guidance on impairment of right-of-use assets in finance leases refer to section 4.3.4, *Impairment of right-of-use assets in finance leases*). Lessees must also apply the guidance in ASC 360-10 when there are significant changes to the current or expected use of a right-of-use asset because it could affect the asset groupings used to evaluate the right-of-use asset for impairment and the estimated useful life of both a right-of-use asset and any leasehold improvements associated with the underlying asset.

Further, lessees that separately account for non-lease components (i.e., entities that have not made the policy election under ASC 842 to combine lease and associated non-lease components) must consider the guidance in ASC 420 to determine whether any exit or disposal costs associated with non-lease components should be accrued (e.g., when a lessee has concluded that it has permanently ceased using an asset, whether for its own use or through subleasing, and costs allocated to the non-lease component that will continue to be incurred for its remaining term will not provide economic benefit to the entity).

The following flowchart illustrates the interaction of the guidance in ASC 842, ASC 360-10 and ASC 420:

**ASC 420**

Determine whether any exit or disposal costs should be accrued.

|  |  |
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| **Contract within the scope of ASC 842** | |
| Lease component (i.e., ROU asset) | Non-lease component\* |

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| **ASC 360-10** |
| **Step 1**  Consider whether impairment indicators are present  (e.g., a decision to abandon an ROU asset). |
| **Step 2**  Compare the sum of the estimated undiscounted future cash flows to the carrying amount of the long- lived asset (asset group). |
| **Step 3**  Measure and record any impairment loss if the carrying amount of the long-lived asset (asset group) exceeds its fair value. |

\* Generally, applies only to lessees that do not make the policy election to combine the lease and associated non-lease components of a contract.

The FASB indicated in the Basis for Conclusions (BC 255) of ASU 2016-02 that the impairment model in ASC 360-10 is appropriate to apply to a lessee’s right-of-use assets because these assets are long-lived nonfinancial assets and should be accounted for the same way as an entity’s other long-lived nonfinancial assets. This treatment is intended to give users of the financial statements comparable information about all of an entity’s long-lived nonfinancial assets.

The guidance in ASC 360-10 requires three steps to identify, recognize and measure the impairment of a long-lived asset (asset group) to be held and used:

* Indicators of impairment (Step 1) — Consider whether impairment indicators are present

(i.e., whether there are any events or changes in circumstances that indicate that the carrying amount of the long-lived asset (asset group) might not be recoverable).

* Test for recoverability (Step 2) — If indicators of impairment are present, perform a recoverability test by comparing the sum of the estimated undiscounted future cash flows attributable to the long- lived asset (asset group) in question to its carrying amount (as a reminder, entities cannot record an impairment for a held and used asset unless the asset first fails this recoverability test).
* Measure an impairment (Step 3) — If the undiscounted cash flows used in the test for recoverability are less than the carrying amount of the long-lived asset (asset group), determine the fair value of the long-lived asset (asset group) and recognize an impairment loss if the carrying amount of the long-lived asset (asset group) exceeds its fair value.

*Grouping long-lived assets*

ASC 360-10 defines an asset group as “the unit of accounting for a long-lived asset or assets to be held and used, which represents the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities.” Assets generally should be grouped when they are used together (i.e., when they are part of the same group of assets and are used together to generate joint cash flows).

Grouping long-lived assets requires judgment and will require consideration of the facts and circumstances as well as an understanding of the entity’s business. We believe the impairment assessment for ROU assets often will be performed at an asset-group level with any impairment allocated among the long-lived assets of the group in accordance with ASC 360-10.

Each time a lessee performs a recoverability test, it should reassess whether its grouping of long-lived assets continues to be appropriate. Significant changes to the current or expected use of the individual assets of the group might indicate that the related asset grouping may have changed. This might be the case even when the ROU asset is not the primary asset in the asset group.

When evaluating whether the inclusion of an ROU asset in an asset group continues to be appropriate, a lessee needs to determine whether there has been a fundamental change in the use of the leased asset. For example, a functionally independent asset that is abandoned (e.g., a building) may no longer be part of an existing asset group. Refer to section 4.2.5.3, *Abandonment of ROU assets*, for discussion on when an ROU asset is abandoned. However, it may be challenging to determine whether an ROU asset that is not (or will not be) abandoned has changed asset groups or is a separate asset group. Examples of situations that could indicate the asset group has changed for an ROU asset that is not (or will not be) abandoned include:

* The lessee has ceased using the leased asset and does not plan to reoccupy or use the leased asset in the future.
* The lessee has incurred significant costs (e.g., readying the space for sublease by removing signage) to cease using the leased asset in the near future.
* The lessee has executed a sublease for the leased asset for substantially all of the remaining lease term.
* The lessee is actively marketing the leased asset for sublease (e.g., hired a broker).
* The lessee has changed how the leased asset is used in its operations, including moving the leased asset to a different line of business in a different asset group.

These situations are not all inclusive, and no one situation is determinative. A lessee will need to evaluate its facts and circumstances to determine whether there is a change in how it uses the leased asset and whether the asset group has changed. A *plan* to change how the leased asset will be used by the business or to sublease the leased asset, by itself, generally does not indicate that the ROU asset’s group has changed, since the lowest level of identifiable cash flows has not yet changed. For example, a lessee may decide that in one year it will sublease a leased asset that is part of an enterprise-wide asset group but it will continue to use the leased asset until then. The ROU asset would still be part of the enterprise-wide asset group because the lessee continues to use the leased asset.

Refer to section 6.3, *Sublessor accounting*, for discussion on evaluating the grouping of long-lived assets when a lessee has executed a sublease for a leased asset in the asset group.

##### Test for recoverability (Step 2)

ASC 360-10 provides principles for evaluating long-lived assets for impairment, but it does not specifically address how lease liabilities should be considered in the recoverability test. Under ASC 360- 10, financial liabilities (e.g., long-term debt) generally are excluded from an asset group and operating liabilities (e.g., accounts payable) generally are included. Financial liabilities generally are excluded because when the FASB was deliberating Statement 144 (later codified in ASC 360-10), it indicated that how an entity capitalizes or finances its operations should not influence the recognition of an impairment loss (see B34 of Statement 144). ASC 360-10 requires an entity to exclude asset retirement obligation (ARO) liabilities from an asset group and to exclude estimated future cash outflows associated with ARO liabilities from both the recoverability test (Step 2) and measurement of an impairment (Step 3).

ASC 842 characterizes operating lease liabilities as operating liabilities. In the Basis for Conclusions (BC 264) of ASU 2016-02, the FASB noted that while both operating and finance lease liabilities are financial liabilities, finance lease liabilities are the equivalent of debt, and operating lease liabilities are operating in nature and not “debt like.”

Because operating lease liabilities may be viewed as having attributes of finance liabilities as well as operating liabilities, we believe it is acceptable for a lessee to either include or exclude operating lease liabilities from an asset group when testing whether the carrying amount of an asset group is recoverable. A lessee should apply its approach (i.e., include or exclude operating lease liabilities) consistently for all operating leases and when performing Steps 2 and 3 of the impairment model in ASC 360-10 (refer to section 4.2.5.2, *Measure an impairment (Step 3),* for guidance on measuring an impairment loss).

In some cases, including operating lease liabilities in an asset group may result in the long-lived asset (asset group) having a zero or negative carrying amount. For example, this may occur if a lessee receives lease incentives or has back-loaded lease payments, both of which would result in reductions to the lessee’s right- of-use assets. In these cases, a lessee is still required to test whether the carrying amount of the asset group is recoverable and, if not recoverable, measure the asset group for impairment.

Determining which future cash outflows for operating lease payments should be included in the Step 2 recoverability test

A lessee that excludes operating lease liabilities from its asset group should exclude future cash lease payments (i.e., fixed, in-substance fixed and variable payments based on an index or rate) in the undiscounted future cash flows.

ASC 360-10 does not specifically address how future cash outflows for operating lease payments should be considered in the recoverability test. The FASB staff said in response to a technical inquiry that if a lessee includes an operating lease liability as part of the carrying amount of the asset group, only the principal component of future lease payments would be included as an outflow in the undiscounted future cash flows used to test recoverability of the asset group. That is, the lessee would include the future cash lease payments for the lease, excluding the component that effectively represents the accretion of the lease liability (even though interest expense is not recognized separately for an operating lease). As a result, we believe a lessee’s decision to include or exclude operating lease liabilities from an asset group generally should not affect the outcome of its recoverability test (refer to Illustration 4-4).

In summary, if a lessee includes operating lease liabilities in its asset group, it should include only the principal component of future cash lease payments in the undiscounted future cash flows. If it excludes operating lease liabilities from its asset group, it should exclude future cash lease payments (i.e., fixed, in-substance fixed and variable payments based on an index or rate) for the lease.

ASC 842 requires lessees to exclude certain variable lease payments from lease payments and, therefore, from the measurement of a lessee’s lease liabilities. Because these payments do not reduce a lessee’s lease liability, we believe the variable payments a lessee expects to make should be included in a lessee’s estimate of undiscounted cash flows in the recoverability test (Step 2), regardless of whether the lessee includes or excludes operating lease liabilities from the asset group. How these payments are included in the lessee’s estimate of future cash flows will depend on the cash flow estimation approach (e.g., probability-weighted, best estimate) it uses. We also believe these variable payments should be included when determining the fair value in Step 3 if the lessee uses a discounted cash flow approach.

As a reminder, a lessee uses its own assumptions to develop estimates of future cash flows in Step 2. This differs from the approach in Step 3, where the lessee measures fair value of the asset group based on market participant assumptions.

Refer to our FRD, [***Impairment or disposal of long-lived assets***](https://www.ey.com/en_us/technical/accountinglink/financial-reporting-developments---impairment-or-disposal-of-lon), for further discussion of evaluating assets for impairment in accordance with ASC 360-10.

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| **Illustration 4-4: Recoverability test for an asset group that is held and used** |
| On 1 January 20X1, a retailer (Lessee) leases space from the owner of a shopping center (Lessor) for 10 years. Under the terms of the agreement, Lessee agrees to pay fixed payments payable on  31 December of each year starting at $10,000 and increasing 2% each year.  Assume the lease is classified as an operating lease, and Lessee’s incremental borrowing rate is 4%. Lessee determines that the appropriate level at which to group assets to test for and measure impairment of long-lived assets is at the store level.  On 1 January 20X4, Lessee identifies a change in circumstances that indicates the carrying amount of the asset group may not be recoverable and performs a recoverability test. On this date, assume that the carrying amount of the asset group, excluding the operating lease liability, is $500,000 and the carrying amount of the operating lease liability is $67,436 (calculation not shown). Also, assume that the cash flow estimation period is seven years and that the undiscounted future expected cash flows per year, excluding lease payments, are $75,000 per year. |

|  |  |  |
| --- | --- | --- |
| **Year** | **Undiscounted future expected cash flows (before lease payments)** | **Total** |
| 1 | $ 75,000 | $ 75,000 |
| 2 | $ 75,000 | $ 75,000 |
| 3 | $ 75,000 | $ 75,000 |
| 4 | $ 75,000 | $ 75,000 |
| 5 | $ 75,000 | $ 75,000 |
| 6 | $ 75,000 | $ 75,000 |
| 7 | $ 75,000 | $ 75,000 |
|  | $ 525,000 | $ 525,000 |

|  |  |
| --- | --- |
| Carrying amount of asset group  (excluding operating lease liability) | $ 500,000 |
| Total undiscounted future expected cash flows | $ 525,000 |
| Excess | $ 25,000 |
| Recoverable? (Yes or No) | Yes |

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Year** | **Undiscounted future expected cash flows (before lease payments)** | **Lease payments** | **Add back portion related to accreted interest** | **Total undiscounted future expected cash flows** |
| 1 | $ 75,000 | (10,612) | 2,697 | $ 67,085 |
| 2 | $ 75,000 | (10,824) | 2,381 | $ 66,557 |
| 3 | $ 75,000 | (11,041) | 2,043 | $ 66,002 |
| 4 | $ 75,000 | (11,262) | 1,683 | $ 65,421 |
| 5 | $ 75,000 | (11,487) | 1,300 | $ 64,813 |
| 6 | $ 75,000 | (11,717) | 893 | $ 64,176 |
| 7 | $ 75,000 | (11,950) | 460 | $ 63,510 |
|  | $ 525,000 | (78,893) | 11,457 | $ 457,564 |

|  |  |
| --- | --- |
| Carrying amount of asset group  (excluding operating lease liability) | $ 500,000 |
| Carrying amount of operating lease liability | (67,436) |
| Carrying amount of asset group (including operating lease liability) | $ 432,564 |
| Total undiscounted future expected cash flows | $ 457,564 |
| Excess | $ 25,000 |
| Recoverable? (Yes or No) | Yes |

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| --- |
| **Scenario 1**  Lessee excludes the operating lease liability from the asset group when determining the carrying amount of the asset group and, therefore, excludes the cash outflows for lease payments in determining the undiscounted future expected cash flows of the asset group.  **Scenario 2**  Lessee includes the operating lease liability in the asset group when determining the carrying amount of the asset group and, therefore, includes the cash outflows for the principal portion of the lease payments in determining the undiscounted future expected cash flows of the asset group.  As shown in Scenario 2, including the operating lease liability in the asset group results in the same outcome as the recoverability test in Scenario 1. This is because by excluding accreted interest from the undiscounted future cash flows both the carrying amount of the asset group and the undiscounted future cash flows are reduced by the existing discounted lease obligation (i.e., $67,436). |

##### Measure an impairment (Step 3)

If the undiscounted cash flows used in the recoverability test are less than the carrying amount of the long- lived asset (asset group), an entity is required to determine the fair value of the long-lived asset (asset group) and recognize an impairment loss when the carrying amount of the long-lived asset (asset group) exceeds its fair value.

We believe that if a lessee excludes operating lease liabilities from the asset group when performing the recoverability test, it also should exclude operating lease liabilities from the asset group when measuring the group’s fair value. Alternatively, if a lessee includes operating lease liabilities in the asset group when performing the recoverability test, it also should include operating lease liabilities in the asset group when determining the group’s fair value.

Regardless of which approach a lessee chooses, we generally do not expect significant differences in the measurement of an impairment loss because we would expect a lessee’s estimate of the fair value of the asset group to appropriately reflect whether the asset group includes or excludes operating lease liabilities. For example, consistent with the guidance in ASC 360-10 for AROs, if a lessee excludes operating lease liabilities from the carrying amount of an asset group but the fair value of the asset group is based on a quoted market price that considers the lessee’s obligation to make lease payments, the quoted market price should be increased by the fair value of the operating lease liabilities. Alternatively, if a lessee includes operating lease liabilities in the carrying amount of an asset group but the fair value of the asset group is based on a quoted market price that does not consider the lessee’s obligation to make lease payments, the quoted market price should be decreased by the fair value of the operating lease liabilities.

If the fair value of the asset group is determined based on discounted cash flows, the market participant cash flows should be adjusted to align with an entity’s decision to include or exclude operating lease liabilities in the carrying amount of the asset group. If the carrying amount of the asset group includes operating lease liabilities, the market participant discounted cash flows used to estimate fair value should include both principal and interest payments, unlike the cash flows used in the recoverability test, which, as discussed above, exclude the component of the operating lease payments that effectively represents the accretion of the lease liability.

While we may not expect including or excluding the lease liability to cause significant differences in the measurement of impairments, measurement differences could exist in some circumstances (e.g., due to decreases in the fair value of the lease liability relative to its carrying amount).

As a reminder, in accordance with ASC 360-10, an impairment loss for an asset group reduces only the carrying amounts of long-lived assets of the group (including lease-related right-of-use assets). The loss must be allocated to the long-lived assets of the group on a pro rata basis using the relative carrying amounts of those assets, except that the loss allocated to an individual long-lived asset of the group must not reduce the carrying amount of that asset below its fair value whenever the fair value is determinable without undue cost and effort.

ASC 360-10 prohibits the subsequent reversal of an impairment loss for an asset held and used.

|  |
| --- |
| **Illustration 4-5: Measurement of impairment for an asset group that is held and used** |
| On 1 January 20X2, Lessee enters into a five-year lease of an asset. Lease payments are fixed at $10,000 per year due on 31 December of each year. The lease is classified as an operating lease, and Lessee’s incremental borrowing rate is 5%. Assume that Lessee has no other assets or liabilities that should be grouped with the operating lease right-of-use asset and liability for purpose of testing for impairment. |

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| On 1 January 20X4, Lessee identifies a change in circumstances that indicates the carrying amount of the right-of-use asset ($27,232) may not be recoverable and performs a recoverability test. Lessee determines that the right-of-use asset is not recoverable (i.e., the carrying amount of the right-of-use asset is greater than the related entity-specific undiscounted cash flows) and, therefore, needs to determine whether the carrying amount of the asset exceeds its fair value and, if so, measure and recognize an impairment loss.  Lessee determines that the fair value of the right-of-use asset is $20,000, based on its estimate of the amount a market participant would be willing to pay up front in one payment for the right to use the asset for three years in its highest and best use assuming no additional lease payments would be due.  **Scenario 1**  Lessee’s approach for determining and measuring impairment in long-lived asset groups is to exclude operating lease liabilities from the asset group.  **Carrying amount Fair value Measured impairment loss**  ROU asset $ 27,232 $ 20,000  Lease liability $ 0 $ 0  $ 27,232 $ 20,000 $ (7,232)  In Scenario 1, Lessee would recognize an impairment loss of $7,232, reducing the carrying amount of the right-of-use asset by that amount.  **Scenario 2**  Assume the same facts as in Scenario 1 except that Lessee’s approach for determining and measuring impairment in long-lived asset groups is to include operating lease liabilities in the asset group, which results in the asset group having a carrying amount of zero. Lessee determines that the right-of-use asset is not recoverable because the entity-specific undiscounted cash flows are negative. Also, assume there has not been a significant change in the lessee’s credit quality or interest rates since 1 January 20X2 such that the fair value of the lease liability is determined to be the same as its carrying amount (i.e., $27,232). | | | |
|  | **Carrying amount** | **Fair value** | **Measured impairment loss** |
| ROU asset $ 27,232 $ 20,000  Lease liability $ (27,232) $ (27,232)  $ 0 $ (7,232) $ (7,232)  In Scenario 2, Lessee would recognize an impairment loss of $7,232, reducing the carrying amount of the right-of-use asset by that amount.  **Scenario 3**  Assume the same facts as Scenario 1 except that Lessee’s approach for determining and measuring impairment in long-lived asset groups is to include operating lease liabilities in the asset group, which results in the asset group having a carrying amount of zero. Lessee determines that the right-of-use asset is not recoverable because the entity-specific undiscounted cash flows are negative. However, further assume that Lessee determines that the fair value of the lease liability is $30,000 due to a significant improvement in its credit quality since 1 January 20X2. | | | |
|  | **Carrying amount** | **Fair value** | **Measured impairment loss** |
| ROU asset $ 27,232 $ 20,000  Lease liability $ (27,232) $ (30,000)  $ 0 $ (10,000) $ (10,000)  In Scenario 3, Lessee would recognize an impairment loss of $7,232, reducing the carrying amount of the right-of-use asset by that amount. Although the measured impairment loss for the asset group is  $10,000, Lessee can reduce only the carrying amount of the long-lived assets in the group (i.e., the right-of-use asset) and cannot reduce the carrying amount of that asset below its fair value whenever the fair value is determinable without undue cost and effort. | | | |

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| **Scenario 4**  Assume the same facts as Scenario 1 except that Lessee’s approach for determining and measuring impairment in long-lived asset groups is to include operating lease liabilities in the asset group, which results in the asset group having a carrying amount of zero. Lessee determines that the right-of-use asset is not recoverable because the entity-specific undiscounted cash flows are negative. However, further assume Lessee determines that the fair value of the lease liability is $15,000 due to a significant deterioration in its credit quality since 1 January 20X2.  In Scenario 4, Lessee would not recognize an impairment loss even though the carrying amount of the right-of-use asset exceeds its fair value by $7,232. |

Fair value considerations

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Carrying amount** | **Fair value** | **Measured impairment loss** |
| ROU asset | $ 27,232 | $ 20,000 |  |
| Lease liability | $ (27,232) | $ (15,000) |  |
|  | $ 0 | $ 5,000 | $ 0 |

ASC 820 provides a principles-based framework for measuring fair value when US GAAP requires or permits a fair value measurement and requires disclosures about the use of fair value measurements. ASC 820 defines fair value 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.”

Under ASC 820, a fair value measurement of a nonfinancial asset takes into account a market participant’s ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use. Therefore, fair value is a market-based measurement and not an entity-specific measurement. It is determined based on assumptions that market participants would use in pricing the asset or liability. The exit price objective of a fair value measurement applies regardless of the reporting entity’s intent and/or ability to sell the asset or transfer the liability at the measurement date.

When determining the fair value of a right-of-use asset, a lessee should consider what market participants would pay to lease the asset (i.e., what a market participant would pay for the right-of-use asset) for its highest and best use, even if that use differs from the current or intended use by the reporting entity. For example, a lessee that currently leases space for use as a grocery store may conclude that the highest and best use of the space by market participants would be to use it as a fitness center.

While the concept of highest and best use of an asset may consider its use in a different condition, the objective of a fair value measurement is to determine the price of the asset in its current form. Therefore, if no market exists for an asset in its current form, but there is a market for the transformed asset, the reporting entity should back out the costs to transform the asset (as well as any associated profit margin) to determine the fair value of the asset in its current condition. That is, a fair value measurement should consider the costs market participants would incur to recondition the asset (after acquiring the asset in its current condition) and the compensation they would expect for this effort.

A contract restriction, which does not allow the lessee to sublease the asset, does not result in a fair value of zero. Instead, a lessee must consider how a market participant would value the right to use the asset with a sublease restriction in a hypothetical sale. Refer to section 5.2.1, *Restrictions on assets (before the adoption of ASU 2022-03)* or section 5.2.1A*, Restrictions on assets (after the adoption of ASU 2022-03)*, of our FRD, [***Fair***](https://www.ey.com/en_us/technical/accountinglink/financial-reporting-developments---fair-value-measurement)[***value measurement***](https://www.ey.com/en_us/technical/accountinglink/financial-reporting-developments---fair-value-measurement), for further discussion on the effect on fair value of a restriction on the use of an asset.

Refer to our FRD, [***Impairment or disposal of long-lived assets***](https://www.ey.com/en_us/technical/accountinglink/financial-reporting-developments---impairment-or-disposal-of-lon), for further discussion of evaluating assets for impairment in accordance with ASC 360-10 and our FRD, [***Fair value measurement***](https://www.ey.com/en_us/technical/accountinglink/financial-reporting-developments---fair-value-measurement), for further discussion on measuring fair value.

Refer to section 6.3, *Sublessor accounting*, for discussion of evaluating right-of-use assets for impairment when a lessee enters into a sublease.

##### Abandonment of ROU assets

A lessee that decides to cease using an underlying asset, either immediately or at a future date (e.g., in 12 months), needs to assess whether the corresponding ROU asset is or will be abandoned. A plan to abandon an ROU asset is considered an indicator of impairment under ASC 360-10 that results in the lessee evaluating the ROU asset (asset group) for recoverability and may also result in the lessee reassessing the lease term and classification under ASC 842. Evaluating a lessee’s intent and ability to sublease an underlying asset is an important factor in determining whether the underlying asset has been or will be abandoned.

If the lessee does not have a contractual right to sublease the underlying asset and the lessee’s cease use of the asset is not temporary, the ROU asset is abandoned at the date the lessee ceases using the underlying asset.

A lessee that has a contractual right to sublease the asset will need to consider the facts and circumstances of the lease and its planned remaining use of the underlying asset. If the lessee may or will sublease the underlying asset, it is not abandoning the ROU asset. As noted in ASC 842-10-15-17, economic benefits from using an asset include subleasing the asset. An entity that may or will sublease an asset (it will not otherwise use) can obtain those economic benefits and, therefore, has not abandoned (or will not abandon) the ROU asset. However, a decision to sublease the underlying asset still may be an indicator of impairment or indicate a change in the asset grouping.

A lessee that has ceased use of the underlying asset and will not sublease it or use it for other purposes (e.g., storage) generally has abandoned the asset. However, if the lessee does not currently plan to sublease or otherwise use the asset but may sublease it in the future (e.g., a lessee may wait to make final decisions until existing economic conditions change or use its right to not sublease as a negotiating tactic when attempting to terminate a lease early), the ROU asset is not or will not be abandoned because the lessee has not yet decided that it will not sublease or otherwise use the underlying asset.

The following flowchart summarizes considerations for determining whether an ROU asset is (or will be) abandoned:

Yes

No

Yes

Has the lessee determined it will not sublease the asset?

Does the lessee have a contractual right to sublease the asset?

The ROU asset is not (or will not be) abandoned.

Has the lessee ceased using the asset permanently (or will it)?

The ROU asset is (or will be) abandoned.

Yes

No No

Accounting for an abandonment

If a lessee determines that it has abandoned an ROU asset or will abandon it at a future date (e.g., in 12 months), it reassesses its lease term if any of the following conditions in ASC 842-10-35-1 exists:

* 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.

If the lease term changes, the lessee also reassesses the lease classification. The existence of an impairment indicator alone does not result in reassessment of the lease term and classification. Refer to section 2.3.6, *Reassessment of the lease term and purchase options*, for further guidance.

Under ASC 360-10, a long-lived asset to be disposed of in a manner other than a sale (e.g., abandonment) is considered held and used until the long-lived asset ceases to be used. Because a decision to abandon a long-lived asset before the end of the lease term is akin to a decision to dispose of a long-lived asset before the initially intended date, a decision to abandon the asset is viewed as an indicator of impairment for a held and used long-lived asset. Therefore, if a lessee decides to abandon an ROU asset, the lessee should test whether the carrying amount of the ROU asset (asset group) is recoverable before abandoning it and, if it is not recoverable, measure it for impairment consistent with the discussion in sections 4.2.5.1, *Test for recoverability (Step 2)*, and 4.2.5.2, *Measure an impairment (Step 3)*.

Prior to assessing impairment, a lessee that abandons or decides to abandon at a future date (e.g., in

12 months) an ROU asset that is part of a larger asset group should first reassess whether its grouping of long-lived assets continues to be appropriate. For example, a functionally independent asset that is abandoned (e.g., a building) may no longer be part of an existing asset group. Refer to section 2.3.1, *Grouping long-lived assets to be held and used*, and section 3.1, *Long-lived assets to be abandoned*, of our FRD, [***Impairment or disposal of long-lived assets***](https://www.ey.com/en_us/technical/accountinglink/financial-reporting-developments---impairment-or-disposal-of-lon), for further discussion of grouping of long-lived assets and abandonment of assets, respectively.

Regardless of whether an ROU asset is impaired, a lessee that commits to a plan to abandon an ROU asset in the future (e.g., in 12 months) but before the end of the lease term should update its estimate of the useful life of the ROU asset. This is consistent with the views expressed by the Securities and Exchange Commission (SEC) staff at the 2020 AICPA Conference on Current SEC and PCAOB Developments.8 The SEC staff discussed a consultation involving a registrant that identified leases for abandonment but expected there to be an extended period of time between the identification of the leases and the abandonment date. After identifying the specific leases that would be abandoned, the registrant did not change the asset group for which it assessed impairment, and it did not recognize an impairment. In this case, the SEC staff did not object to the registrant’s conclusion to re-evaluate the economic life of the ROU assets subject to abandonment and amortize those assets ratably over the period between its identification of leases for abandonment and the actual abandonment date.

The evaluation of whether a lessee has committed to a plan to abandon an ROU asset in the future is based on the facts and circumstances. If the lessee is ceasing to use an asset temporarily (e.g., a lessee plans to vacate a leased office building for one year as part of a restructuring but intends to reoccupy that facility), the temporary abandonment would not result in a reassessment of the useful life of the related ROU asset.

If no impairment is recorded but the useful life is shortened, we believe a lessee would follow the guidance in section 4.2.5.4, *Accounting for an operating lease after an impairment of a right-of-use asset (single lease cost),* to subsequently account for the ROU asset and lease liability and to determine its single lease cost after estimating the useful life of the right-of-use asset. If an impairment is recorded, the lessee measures the ROU asset at its carrying amount immediately after the impairment and follows the guidance in section 4.2.5.4, *Accounting for an operating lease after an impairment of a right-of-use asset (single lease cost),* to subsequently account for the ROU asset and lease liability and to determine its single lease cost.

8 Speech by Geoff Griffin, 7 December 2020. Refer to the SEC website at [**https://www.sec.gov/news/speech/griffin-remarks-**](https://www.sec.gov/news/speech/griffin-remarks-aicpa-2020)[**aicpa-2020**.](https://www.sec.gov/news/speech/griffin-remarks-aicpa-2020)

An ROU asset that has been abandoned should be reduced to its salvage value (or zero, if there is no salvage value) as of its cease-use date. The salvage value of an ROU asset will often be de minimis.

The following flowchart summarizes the accounting considerations for a lessee that abandons an ROU asset or decides to abandon it at a future date (e.g., in 12 months). The flowchart assumes that the lessee has appropriately considered ASC 360-10 up to the date the decision is made to abandon the asset.

Yes

Do any of the conditions in ASC 842-10-35-1 exist (e.g., is the lessee no longer reasonably certain to exercise a renewal option on the asset it has decided to abandon)?

The ROU asset is abandoned, or a decision has been reached to abandon the ROU asset in the future.

Reassess the lease term.

If the lease term changes, also reassess lease classification.

Does the grouping of long-lived assets for purposes of assessing impairment continue to be appropriate (i.e., if the abandoned (or to be abandoned) ROU asset is part of a larger asset group)?

Determine new asset groups.

Is the carrying amount of the ROU asset (asset group) recoverable?

Will the lessee cease using the ROU asset immediately (i.e., not on a date in the future)?

Measure and recognize any impairment loss if the carrying amount of the long-lived asset group exceeds its fair value*.*

Follow ASC 842-20-35-10 and ASC 842-20-25-7

to subsequently account for the ROU asset and lease liability and to determine its single lease cost using the updated useful life of the ROU asset.

Update estimate of the useful life of the ROU asset.

No

No

Yes

No

Yes

No

Yes

Reduce the ROU asset to its salvage value (or zero, if there is no salvage value).

Accounting when there is no abandonment

If a lessee determines that it has not abandoned an ROU asset or will not abandon it at a future date, it should reassess its lease term only if any of the conditions in ASC 842-10-35-1 exists.

Lessees that determine that an ROU asset is not abandoned (e.g., because it may be subleased) should consider whether the temporary cease use (or future plan to temporarily cease use) of the asset is an indicator of impairment in accordance with ASC 360-10. Lessees that determine that an indicator of impairment is present should perform the recoverability test for the asset (or asset group) and measure and record any impairment. In doing so, the lessee should first reassess whether its grouping of long-lived assets continues to be appropriate. If an impairment is recorded, the lessee measures the ROU asset at its carrying amount immediately after the impairment and follows the guidance in ASC 842-20-25-7 and ASC 842-20- 35-10 to subsequently account for the ROU asset and lease liability and to determine its single lease cost.

##### Accounting for an operating lease after an impairment of a right-of-use asset (single lease cost)

If a lessee determines that an operating lease right-of-use asset is impaired, it recognizes an impairment loss and measures the ROU asset at its carrying amount immediately after the impairment. A lessee subsequently amortizes the held-for-use ROU asset, generally on a straight-line basis, from the date of the impairment to the earlier of the end of the useful life of the ROU asset or the end of the lease term. Events or changes in circumstances that indicate the carrying amount of an ROU asset may not be recoverable in accordance with ASC 360-10 that do not occur or arise as a result of an action that is within the control of the lessee do not, in isolation, trigger a reassessment of the lease term or a lessee option to purchase the underlying asset. Refer to section 2.3.6.1, *Reassessment of the lease term and purchase options — lessees*.

If the lease is remeasured after the impairment (e.g., as a result of a modification or a subsequent reassessment event), we believe that a lessee would continue to amortize a held-for-use ROU asset, generally on a straight-line basis, from the date of remeasurement to the earlier of the end of the useful life of the ROU asset or the end of the lease term.

ASC 842 includes the following example of the subsequent accounting for an operating lease following an impairment of the right-of-use asset.

## Finance leases

### Initial measurement — finance leases

The initial measurement of the lease liabilities and right-of-use assets for finance leases is the same as for operating leases.

##### Initial measurement of lease liabilities — finance leases

At the commencement date (refer to section 2.2, *Commencement date of the lease*), a lessee initially measures the lease liability at the present value of the lease payments to be made over the lease term. Lessees apply the concepts previously described in section 1, *Scope and scope exceptions*, and section 2, *Key concepts*, to identify the lease components and to determine the lease term, lease payments and discount rate as of the commencement date of the lease.

The diagram below illustrates the inputs needed to initially calculate the lease liability:

Present value using the discount rate determined on the commencement date

Lease payments to be made over the lease term1

Lease liability

1 Lease incentives that are payable to the lessee on the commencement date are deducted from lease payments (i.e., they reduce the lease liability). Refer to section 2.4.1.2, *Lease incentives*.

##### Initial measurement of right-of-use assets — finance leases

A lessee initially measures the right-of-use asset at cost, which consists of all of the following:

* The amount of the initial measurement of the lease liability
* Any lease payments made to the lessor at or before the commencement date, less any lease incentives received (refer to section 2.4.1.2, *Lease incentives*)
* Any initial direct costs incurred by the lessee (refer to section 2.6, *Initial direct costs*) The diagram below illustrates the inputs needed to initially calculate the ROU asset:

Lease liability

Lease prepayments

Initial direct costs

Lease incentives received

ROU asset

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

### Subsequent measurement — finance leases

##### Subsequent measurement of lease liabilities — finance leases

The FASB indicated in the Basis for Conclusions (BC 223) of ASU 2016-02 that a lease liability for finance leases should be accounted for in a manner similar to other financial liabilities (i.e., on an amortized cost basis). Consequently, the lease liability for finance leases is accreted using an amount that produces a constant periodic discount rate on the remaining balance of the liability (i.e., the discount rate determined at commencement, as long as a reassessment requiring a change in the discount rate has not been triggered) (refer to section 2.5.3, *Reassessment of the discount rate*). Lease payments reduce the lease liability as they are paid.

Periodic lease payments on finance leases are allocated between a reduction of the lease liability and interest expense to produce a constant periodic interest rate on the remaining balance of the lease liability. This will result in a remaining balance of the lease liability at the end of the lease term equal to the amount of any of the following that were included in lease payments used to measure the lease liability (refer to section 2.4, *Lease payments*):

* The exercise price of a purchase option (refer to section 2.4.3, *The exercise price of a purchase option*)
* Amounts that it is probable a lessee will owe under a residual value guarantee (refer to section 2.4.6,

*Amount it is probable that a lessee will owe under residual value guarantees — lessees only*)

* A termination penalty (refer to section 2.4.4, *Payments for penalties for terminating a lease*)

While ASC 842 describes the subsequent measurement of a finance lease liability differently from that of an operating lease liability, from a practical perspective, we expect the lease liability balance to be the same. The difference in the expense recognition pattern of an operating lease (i.e., generally straight-line expense) and a finance lease (i.e., generally front-loaded expense) is driven by the subsequent accounting for the right-of-use asset.

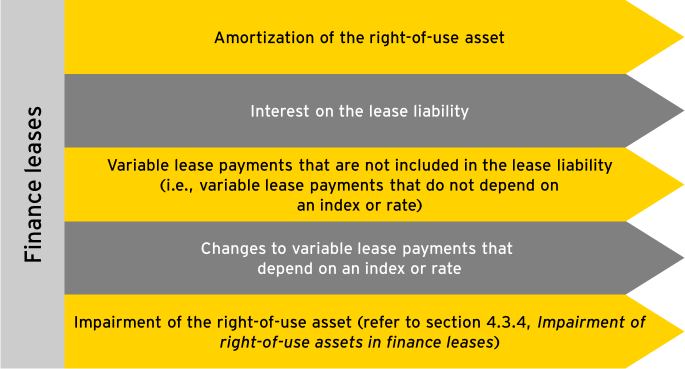
##### Subsequent measurement of right-of-use assets — finance leases

Amortization of the right-of-use asset is recognized in a manner consistent with existing guidance for nonfinancial assets that are measured at cost. Lessees amortize the right-of-use asset on a straight-line basis, unless another systematic basis better represents the pattern in which the lessee expects to consume the right-of-use asset’s future economic benefits. The right-of-use asset is amortized from the lease 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, the amortization period is the remaining useful life of the underlying asset if the lessee is reasonably certain to exercise an option to purchase the underlying asset or if the lease transfers ownership of the underlying asset to the lessee by the end of the lease term.

Refer to section 4.3.5, *Example — lessee accounting for a finance lease*, for a comprehensive example.

### Expense recognition — finance leases (updated July 2024)

When subsequently accounting for a finance lease, lessees recognize the following:



To clarify, a lessee’s lease cost 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 applicable guidance, such as ASC 330.

Amortization of the right-of-use asset and interest on the lease liability

After the commencement date, a lessee recognizes amortization of the right-of-use asset and separately recognizes interest on the lease liability for a finance lease. The recognition of interest and amortization for finance leases is consistent with a view that such leases are effectively installment purchases. That is, the lessee is paying to finance the acquisition of the underlying asset that will be consumed during the lease term.

The total periodic cost (i.e., the sum of interest and amortization) of a finance lease is typically higher in the early periods and lower in the later periods. Because a constant interest rate is applied to the lease liability, interest decreases as cash payments are made during the lease term and the lease liability decreases. Therefore, more interest is incurred in the early periods and less in the later periods. This trend in interest, combined with the straight-line amortization of the right-of-use asset, results in a front- loaded cost recognition pattern.

Variable lease payments

After the commencement date, lessees also recognize as part of lease-related cost any variable lease payments not included in the finance lease liability in the period in which the achievement of the specified target that triggers the variable lease payments becomes probable. Any previously recognized variable lease costs are reversed if it becomes probable that the specified target will no longer be met. ASC 842 does not specify the income statement presentation of variable lease costs once they become probable. We believe variable lease costs are generally presented as interest expense but could also be appropriately presented as lease expense (i.e., operating expense) when not otherwise capitalized in the cost of another asset, such as inventory under ASC 330. An entity should consider the presentation of the variable lease payments based on its specific circumstances. Refer to section 2.4.10, *Amounts not included in lease payments*, for a discussion of variable lease payments that do not depend on an index or rate.

Impairment of the right-of-use asset

If a lessee determines that a finance lease right-of-use asset is impaired, it recognizes an impairment loss and measures the right-of-use asset at its carrying amount immediately after the impairment. A lessee subsequently amortizes, generally on a straight-line basis, the right-of-use asset from the date of the impairment to the earlier of the end of the useful life of the right-of-use asset or the end of the lease term. However, the amortization period is the remaining useful life of the underlying asset if the lessee is reasonably certain to exercise an option to purchase the underlying asset or if the lease transfers ownership of the underlying asset to the lessee by the end of the lease term. Refer to section 4.3.4, *Impairment of right-of-use assets in finance leases*, for additional discussion of impairment of right-of-use assets.

### Impairment of right-of-use assets in finance leases (updated August 2023)

A lessee’s right-of-use asset in an operating or finance lease is subject to the impairment guidance in

ASC 360-10 (for guidance on impairment of right-of-use assets in operating leases refer to section 4.2.5, *Impairment of right-of-use assets in operating leases*). Lessees must also apply the guidance in ASC 360-10 when there are significant changes to the current or expected use of a right-of-use asset because it could affect the asset groupings used to evaluate the right-of-use asset for impairment and the estimated useful life of both an right-of-use asset and any leasehold improvements associated with the underlying asset.

Further, lessees that separately account for non-lease components (i.e., entities that have not made the policy election under ASC 842 to combine lease and associated non-lease components) must consider the guidance in ASC 420 to determine whether any exit or disposal costs associated with non-lease components should be accrued (e.g., when a lessee has concluded that it has permanently ceased using an asset, whether for its own use or through subleasing, and costs allocated to the non-lease component that will continue to be incurred for its remaining term will not provide economic benefit to the entity).

The following flowchart illustrates the interaction of the guidance in ASC 842, ASC 360-10 and ASC 420:

**ASC 420**

|  |  |
| --- | --- |
| **Contract within the scope of ASC 842** | |
| Lease component (i.e., ROU asset) | Non-lease component\* |

|  |
| --- |
| **ASC 360-10** |
| **Step 1**  Consider whether impairment indicators are present  (e.g., a decision to abandon an ROU asset). |
| **Step 2**  Compare the sum of the estimated undiscounted future cash flows to the carrying amount of the long- lived asset (asset group). |
| **Step 3**  Measure and record any impairment loss if the carrying amount of the long-lived asset (asset group) exceeds its fair value. |

Determine whether any exit or disposal costs should be accrued.

\* Generally, applies only to lessees that do not make the policy election to combine the lease and associated non-lease components of a contract.

The FASB indicated in the Basis for Conclusions (BC 255) of ASU 2016-02 that the impairment model in ASC 360-10 is appropriate to apply to a lessee’s right-of-use assets because these assets are long-lived nonfinancial assets and should be accounted for the same way as an entity’s other long-lived nonfinancial assets. This treatment is intended to give users of the financial statements comparable information about all of an entity’s long-lived nonfinancial assets.

The guidance in ASC 360-10 requires three steps to identify, recognize and measure the impairment of a long-lived asset (asset group) to be held and used:

* Indicators of impairment (Step 1) — Consider whether impairment indicators are present

(i.e., whether there are any events or changes in circumstances that indicate that the carrying amount of the long-lived asset (asset group) might not be recoverable).

* Test for recoverability (Step 2) — If indicators of impairment are present, perform a recoverability test by comparing the sum of the estimated undiscounted future cash flows attributable to the long- lived asset (asset group) in question to its carrying amount (as a reminder, entities cannot record an impairment for a held and used asset unless the asset first fails this recoverability test) .
* Measure an impairment (Step 3) — If the undiscounted cash flows used in the test for recoverability are less than the carrying amount of the long-lived asset (asset group), determine the fair value of the long-lived asset (asset group) and recognize an impairment loss if the carrying amount of the long-lived asset (asset group) exceeds its fair value.

Grouping long-lived assets

ASC 360-10 defines an asset group as “the unit of accounting for a long-lived asset or assets to be held and used, which represents the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities.” Assets generally should be grouped when they are used together (i.e., when they are part of the same group of assets and are used together to generate joint cash flows).

Grouping long-lived assets requires judgment and will require consideration of the facts and circumstances as well as an understanding of the entity’s business. We believe the impairment assessment for ROU assets often will be performed at an asset-group level with any impairment allocated among the long-lived assets of the group in accordance with ASC 360-10.

Each time a lessee performs a recoverability test, it should reassess whether its grouping of long-lived assets continues to be appropriate. Significant changes to the current or expected use of the individual assets of the group might indicate that the related asset grouping may have changed. This might be the case even when the ROU asset is not the primary asset in the asset group.

When evaluating whether the inclusion of an ROU asset in an asset group continues to be appropriate, a lessee needs to determine whether there has been a fundamental change in the use of the leased asset. For example, a functionally independent asset that is abandoned (e.g., a building) may no longer be part of an existing asset group. Refer to section 4.2.5.3, *Abandonment of ROU assets*, for discussion on when an ROU asset is abandoned. However, it may be challenging to determine whether an ROU asset that is not (or will not be) abandoned has changed asset groups or is a separate asset group. Examples of situations that could indicate the asset group has changed for an ROU asset that is not (or will not be) abandoned include:

* The lessee has ceased using the leased asset and does not plan to reoccupy or use the leased asset in the future.
* The lessee has incurred significant costs (e.g., readying the space for sublease by removing signage) to cease using the leased asset in the near future.
* The lessee has executed a sublease for the leased asset for substantially all of the remaining lease term.
* The lessee is actively marketing the leased asset for sublease (e.g., hired a broker).
* The lessee has changed how the leased asset is used in its operations, including moving the leased asset to a different line of business in a different asset group.

These situations are not all inclusive, and no one situation is determinative. A lessee will need to evaluate its facts and circumstances to determine whether there is a change in how it uses the leased asset and whether the asset group has changed. A *plan* to change how the leased asset will be used by the business or to sublease the leased asset, by itself, generally does not indicate that the ROU asset’s group has changed, since the lowest level of identifiable cash flows has not yet changed. For example, a lessee may decide that in one year it will sublease a leased asset that is part of an enterprise-wide asset group but it will continue to use the leased asset until then. The ROU asset would still be part of the enterprise-wide asset group because the lessee continues to use the leased asset.

Refer to section 6.3, *Sublessor accounting*, for discussion on evaluating the grouping of long-lived assets when a lessee has executed a sublease for a leased asset in the asset group.

##### Test for recoverability (Step 2)

ASC 360-10 provides principles for evaluating long-lived assets for impairment, but it does not specifically address how lease liabilities should be considered in the recoverability test. Under ASC 360-10, financial liabilities (e.g., long-term debt) generally are excluded from an asset group and operating liabilities

(e.g., accounts payable) generally are included. Financial liabilities generally are excluded because when the FASB was deliberating Statement 144 (later codified in ASC 360-10), it indicated that how an entity capitalizes or finances its operations should not influence the recognition of an impairment loss (see B34 of Statement 144). ASC 360-10 requires an entity to exclude asset retirement obligation (ARO) liabilities from an asset group and to exclude estimated future cash outflows associated with ARO liabilities from both the recoverability test (Step 2) and measurement of an impairment (Step 3).

In the Basis for Conclusions (BC 264) of ASU 2016-02, the FASB noted that while both operating and finance lease liabilities are financial liabilities, finance lease liabilities are the equivalent of debt, and operating lease liabilities are operating in nature and not “debt like.” Therefore, we generally believe it would be most appropriate to exclude finance lease liabilities from an asset group when testing whether the asset group is recoverable and determining the fair value of the asset group.

A lessee should apply its approach (i.e., include or exclude finance lease liabilities) consistently for all finance leases and when performing Steps 2 and 3 of the impairment model in ASC 360-10 (refer to section 4.3.4.2, *Measure an impairment (Step 3),* for guidance on measuring an impairment loss).

In some cases, including finance lease liabilities in an asset group may result in the long-lived asset (asset group) having a zero or negative carrying amount. For example, this may occur with the passage of time or if a lessee receives lease incentives or has back-loaded lease payments, all of which would result in reductions to the lessee’s right-of-use assets. In these cases, a lessee is still required to test whether the carrying amount of the asset group is recoverable and, if not recoverable, measure the asset group for impairment.

Determining which future cash outflows for lease payments should be included in the Step 2 recoverability test

A lessee that excludes finance lease liabilities from its asset group should exclude future cash lease payments (i.e., fixed, in-substance fixed and variable payments based on an index or rate) in the undiscounted future cash flows. If a lessee includes finance lease liabilities in its asset group, only the principal component of future lease payments would be included as an outflow in the undiscounted future cash flows used to test recoverability of the asset group. That is, the lessee would include the future cash lease payments for the lease, excluding the component that represents the accretion of the lease liability.

ASC 842 requires lessees to exclude certain variable lease payments from lease payments and, therefore, from the measurement of a lessee’s lease liabilities. Because these payments do not reduce a lessee’s lease liability, we believe the variable payments a lessee expects to make should be included in a lessee’s estimate of undiscounted cash flows in the recoverability test (Step 2), regardless of whether the lessee includes or excludes finance lease liabilities from the asset group. How these payments are included in the lessee’s estimate of future cash flows will depend on the cash flow estimation approach (e.g., probability- weighted, best estimate) it uses. We also believe these variable payments should be included when determining the fair value in Step 3 if the lessee uses a discounted cash flow approach.

As a reminder, a lessee uses its own assumptions to develop estimates of future cash flows in Step 2. This differs from the approach in Step 3, where the lessee measures fair value of the asset group based on market participant assumptions.

Refer to our FRD, [***Impairment or disposal of long-lived assets***](https://www.ey.com/en_us/technical/accountinglink/financial-reporting-developments---impairment-or-disposal-of-lon), for further discussion of evaluating assets for impairment in accordance with ASC 360-10.

##### Measure an impairment (Step 3)

If the undiscounted cash flows used in the recoverability test are less than the carrying amount of the long-lived asset (asset group), an entity is required to determine the fair value of the long-lived asset (asset group) and recognize an impairment loss when the carrying amount of the long-lived asset (asset group) exceeds its fair value.

We believe that if a lessee excludes finance lease liabilities from the asset group when performing the recoverability test, it also should exclude finance lease liabilities from the asset group when measuring the group’s fair value. Alternatively, if a lessee includes finance lease liabilities in the asset group when performing the recoverability test, it also should include finance lease liabilities in the asset group when determining the group’s fair value.

Regardless of which approach a lessee chooses, we generally do not expect significant differences in the measurement of an impairment loss because we would expect a lessee’s estimate of the fair value of the asset group to appropriately reflect whether the asset group includes or excludes finance lease liabilities. For example, consistent with the guidance in ASC 360-10 for AROs, if a lessee excludes finance lease liabilities from the carrying amount of an asset group but the fair value of the asset group is based on a quoted market price that considers the lessee’s obligation to make lease payments, the quoted market price should be increased by the fair value of the finance lease liabilities. Alternatively, if a lessee includes finance lease liabilities in the carrying amount of an asset group but the fair value of the asset group is based on a quoted market price that does not consider the lessee’s obligation to make lease payments, the quoted market price should be decreased by the fair value of the finance lease liabilities.

If the fair value of the asset group is determined based on discounted cash flows, the market participant cash flows should be adjusted to align with an entity’s decision to include or exclude finance lease liabilities in the carrying amount of the asset group. If the carrying amount of the asset group includes finance lease liabilities, the market participant discounted cash flows used to estimate fair value should include both principal and interest payments, unlike the cash flows used in the recoverability test, which, as discussed above, exclude the component of the finance lease payments that represents the accretion of the lease liability.

While we may not expect including or excluding the lease liability to cause significant differences in the measurement of impairments, measurement differences could exist in some circumstances (e.g., due to decreases in the fair value of the lease liability relative to its carrying amount).

As a reminder, in accordance with ASC 360-10, an impairment loss for an asset group reduces only the carrying amounts of long-lived assets of the group (including lease-related right-of-use assets). The loss must be allocated to the long-lived assets of the group on a pro rata basis using the relative carrying amounts of those assets, except that the loss allocated to an individual long-lived asset of the group must not reduce the carrying amount of that asset below its fair value whenever the fair value is determinable without undue cost and effort. ASC 360-10 prohibits the subsequent reversal of an impairment loss for an asset held and used.

Fair value considerations

ASC 820 provides a principles-based framework for measuring fair value when US GAAP requires or permits a fair value measurement and requires disclosures about the use of fair value measurements. ASC 820 defines fair value 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.”

Under ASC 820, a fair value measurement of a nonfinancial asset takes into account a market participant’s ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use. Therefore, fair value is a market-based measurement and not an entity-specific measurement. It is determined based on assumptions that market participants would use in pricing the asset or liability. The exit price objective of a fair value measurement applies, regardless of the reporting entity’s intent and/or ability to sell the asset or transfer the liability at the measurement date.

When determining the fair value of a right-of-use asset, a lessee should consider what market participants would pay to lease the asset (i.e., what a market participant would pay for the right-of-use asset) for its highest and best use, even if that use differs from the current or intended use by the reporting entity. For example, a lessee that currently leases space for use as a grocery store may conclude that the highest and best use of the space by market participants would be to use it as a fitness center.

While the concept of highest and best use of an asset may consider its use in a different condition, the objective of a fair value measurement is to determine the price of the asset in its current form. Therefore, if no market exists for an asset in its current form, but there is a market for the transformed asset, the reporting entity should back out the costs to transform the asset (as well as any associated profit margin) to determine the fair value of the asset in its current condition. That is, a fair value measurement should consider the costs market participants would incur to recondition the asset (after acquiring the asset in its current condition) and the compensation they would expect for this effort.

A contract restriction, which does not allow the lessee to sublease the asset, does not result in a fair value of zero. Instead, a lessee must consider how a market participant would value the right to use the asset with a sublease restriction in a hypothetical sale. Refer to section 5.2.1, *Restrictions on assets (before the adoption of ASU 2022-03)*, or section 5.2.1A*, Restrictions on assets (after the adoption of ASU 2022- 03)*, of our FRD, [***Fair value measurement***](https://www.ey.com/en_us/technical/accountinglink/financial-reporting-developments---fair-value-measurement), for further discussion on the effect on fair value of a restriction on the use of an asset.

Refer to our FRD, [***Impairment or disposal of long-lived assets***](https://www.ey.com/en_us/technical/accountinglink/financial-reporting-developments---impairment-or-disposal-of-lon), for further discussion of evaluating assets for impairment in accordance with ASC 360-10 and our FRD, [***Fair value measurement***](https://www.ey.com/en_us/technical/accountinglink/financial-reporting-developments---fair-value-measurement), for further discussion on measuring fair value.

Refer to section 6.3, *Sublessor accounting*, for discussion of evaluating right-of-use assets for impairment when a lessee enters into a sublease.

##### Abandonment of ROU assets

A lessee that decides to cease using an underlying asset, either immediately or at a future date (e.g., in 12 months), needs to assess whether the corresponding ROU asset is or will be abandoned. A plan to abandon an ROU asset is considered an indicator of impairment under ASC 360-10 that results in the lessee evaluating the ROU asset (asset group) for recoverability and may also result in the lessee reassessing the lease term and classification under ASC 842. Evaluating a lessee’s intent and ability to sublease an underlying asset is an important factor in determining whether the underlying asset has been or will be abandoned.

If the lessee does not have a contractual right to sublease the underlying asset and the lessee’s cease use of the asset is not temporary, the ROU asset is abandoned at the date the lessee ceases using the underlying asset.

A lessee that has a contractual right to sublease the asset will need to consider the facts and circumstances of the lease and its planned remaining use of the underlying asset. If the lessee may or will sublease the underlying asset, it is not abandoning the ROU asset. As noted in ASC 842-10-15-17, economic benefits from using an asset include subleasing the asset. An entity that may or will sublease an asset (it will not otherwise use) can obtain those economic benefits and, therefore, has not abandoned (or will not abandon) the ROU asset. However, a decision to sublease the underlying asset still may be an indicator of impairment or indicate a change in the asset grouping.

A lessee that has ceased use of the underlying asset and will not sublease it or use it for other purposes (e.g., storage) generally has abandoned the asset. However, if the lessee does not currently plan to sublease or otherwise use the asset but may sublease it in the future (e.g., a lessee may wait to make final decisions until existing economic conditions change or use its right to not sublease as a negotiating tactic when attempting to terminate a lease early), the ROU asset is not or will not be abandoned because the lessee has not yet decided that it will not sublease or otherwise use the underlying asset.

The following flowchart summarizes considerations for determining whether an ROU asset is (or will be) abandoned:

Yes

No

Yes

Has the lessee determined it will not sublease the asset?

Does the lessee have a contractual right to sublease the asset?

The ROU asset is not (or will not be) abandoned.

Has the lessee ceased using the asset permanently (or will it)?

The ROU asset is (or will be) abandoned.

Yes

No No

Accounting for an abandonment

If a lessee determines that it has abandoned an ROU asset or will abandon it at a future date, it reassesses its lease term if any of the following conditions in ASC 842-10-35-1 exists:

* 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.

If the lease term changes, the lessee also reassesses the lease classification. The existence of an impairment indicator alone does not result in reassessment of the lease term and classification. Refer to section 2.3.6, *Reassessment of the lease term and purchase options,* for further guidance.

Under ASC 360-10, a long-lived asset to be disposed of in a manner other than a sale (e.g., abandonment) is considered held and used until the long-lived asset ceases to be used. Because a decision to abandon a long-lived asset before the end of the lease term is akin to a decision to dispose of a long-lived asset before the initially intended date, a decision to abandon the asset is viewed as an indicator of impairment for a held and used long-lived asset. Therefore, if a lessee decides to abandon an ROU asset, the lessee should test whether the carrying amount of the ROU asset (asset group) is recoverable before abandoning it and, if it is not recoverable, measure it for impairment consistent with the discussion in sections 4.3.4.1, *Test for recoverability (Step 2)*, and 4.3.4.2, *Measure an impairment (Step 3)*.

Prior to assessing impairment, a lessee that abandons or decides to abandon at a future date (e.g., in

12 months) an ROU asset that is part of a larger asset group should first reassess whether its grouping of long-lived assets continues to be appropriate. For example, a functionally independent asset that is abandoned (e.g., a building) may no longer be part of an existing asset group. Refer to section 2.3.1, *Grouping long-lived assets to be held and used*, and section 3.1, *Long-lived assets to be abandoned*, of our FRD, [***Impairment or disposal of long-lived assets***](https://www.ey.com/en_us/technical/accountinglink/financial-reporting-developments---impairment-or-disposal-of-lon), for further discussion of grouping of long-lived assets and abandonment of assets, respectively.

Regardless of whether an ROU asset is impaired, a lessee that commits to a plan to abandon an ROU asset in the future (e.g., in 12 months) but before the end of the lease term should update its estimate of the useful life of the ROU asset. This is consistent with the views expressed by the SEC staff at the 2020 AICPA Conference on Current SEC and PCAOB Developments. Refer to section 4.2.5.3, *Abandonment of ROU assets*, for a summary of the SEC staff’s views.

The evaluation of whether a lessee has committed to a plan to abandon an ROU asset in the future is based on the facts and circumstances. If the lessee is ceasing to use an asset temporarily (e.g., a lessee plans to vacate a leased office building for one year as part of a restructuring but intends to reoccupy that facility), the temporary abandonment would not result in a reassessment of the useful life of the related ROU asset.

If no impairment is recorded but the useful life is shortened, we believe a lessee would follow the guidance in section 4.3.4.4, *Accounting for a finance lease after an impairment of an ROU asset*, to subsequently account for the ROU asset after updating its estimate of the useful life of the ROU asset. If an impairment is recorded, the lessee measures the ROU asset at its carrying amount immediately after the impairment and follows the guidance in section 4.3.4.4, *Accounting for a finance lease after an impairment of an ROU asset*, to subsequently account for the ROU asset. Absent a modification, there is no change in how the lessee accounts for the lease liability throughout the remaining lease term.

An ROU asset that has been abandoned should be reduced to its salvage value (or zero, if there is no salvage value) as of its cease-use date. The salvage value of an ROU asset will often be de minimis.

The following flowchart summarizes the accounting considerations for a lessee that abandons an ROU asset or decides to abandon it at a future date (e.g., in 12 months). The flowchart assumes that the lessee has appropriately considered ASC 360-10 up to the date the decision is made to abandon the asset.

Yes



Follow ASC 842-20-35-10 and ASC 842-20-35-7

to subsequently account for the ROU asset and lease liability.

Update estimate of the useful life of the ROU asset.

Will the lessee cease using the ROU asset immediately (i.e., not on a date in the future)?

Measure and recognize any impairment loss if the carrying amount of the long-lived asset group exceeds its fair value*.*

Is the carrying amount of the ROU asset (asset group) recoverable?

Determine new asset groups.

No

No

Does the grouping of long-lived assets for purposes of assessing impairment continue to be appropriate (i.e., if the abandoned (or to be abandoned) ROU asset is part of a larger asset group)?

Yes

Do any of the conditions in ASC 842-10-35-1 exist (e.g., is the lessee no longer reasonably certain to exercise a renewal option on the asset it has decided to abandon)?

The ROU asset is abandoned, or a decision has been reached to abandon the ROU asset in the future.

Reassess the lease term.

If the lease term changes, also reassess lease classification.

No

Yes

No

Yes

Reduce the ROU asset to its salvage value (or zero, if there is no salvage value).

Accounting when there is no abandonment

If a lessee determines that it has not abandoned an ROU asset or will not abandon it at a future date, it should reassess its lease term only if any of the conditions in ASC 842-10-35-1 exist.

Lessees that determine that an ROU asset is not abandoned (e.g., because it may be subleased) should consider whether the temporary cease use (or future plan to temporarily cease use) of the asset is an indicator of impairment in accordance with ASC 360-10. Lessees that determine that an indicator of impairment is present should perform the recoverability test for the asset (or asset group) and measure and record any impairment. In doing so, the lessee should first reassess whether its grouping of long- lived assets continues to be appropriate. If an impairment is recorded, the lessee measures the ROU asset at its carrying amount immediately after the impairment and follows the guidance in ASC 842-20- 35-7 and ASC 842-20-35-10 to subsequently account for the ROU asset and lease liability.

##### Accounting for a finance lease after an impairment of an ROU asset

If a lessee determines that a finance lease right-of-use asset is impaired, it recognizes an impairment loss and measures the right-of-use asset at its carrying amount immediately after the impairment. A lessee subsequently amortizes, generally on a straight-line basis, the right-of-use asset from the date of the impairment to the earlier of the end of the useful life of the right-of-use asset or the end of the lease term. However, the amortization period is the remaining useful life of the underlying asset if the lessee is reasonably certain to exercise an option to purchase the underlying asset or if the lease transfers ownership of the underlying asset to the lessee by the end of the lease term. Refer to section 4.3.4, *Impairment of right-of-use assets in finance leases*, for additional discussion of impairment of right-of-use assets. Events or changes in circumstances that indicate the carrying amount of an ROU asset may not be recoverable in accordance with ASC 360-10 that do not occur or arise as a result of an action that is within the control of the lessee do not, in isolation, trigger a reassessment of the lease term or a lessee option to purchase the underlying asset. Refer to section 2.3.6.1, *Reassessment of the lease term and purchase options — lessees*.

### Example — lessee accounting for a finance lease

|  |
| --- |
| **Illustration 4-6: Lessee accounting for a finance lease** |
| Entity H (lessee) makes a payment of $5,000 to an existing tenant to obtain a lease and enters into a three- year lease of the same equipment that it concludes is a finance lease because the lease term is for a major part of the remaining economic life of the underlying asset (also three years). The lease commences at the beginning of Year 1. Entity H agrees to make the following annual payments at the end of each year:  $10,000 in Year 1, $12,000 in Year 2 and $14,000 in Year 3. Entity H concludes that the $5,000 payment to the former tenant qualifies as an IDC. For simplicity, there are no purchase options, payments to the lessor before the lease commencement date, variable payments based on an index or rate, or lease incentives from the lessor. The initial measurement of the right-of-use asset and lease liability is $33,000 (present value of lease payments using a discount rate of 4.235%). Entity H uses its incremental borrowing rate because the rate implicit in the lease cannot be readily determined. Entity H amortizes the right-of- use asset on a straight-line basis over the lease term. |

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | **Initial** | **Year 1** | **Year 2** | **Year 3** |
| Cash lease payments |  | $ 10,000 | $ 12,000 | $ 14,000 |
| *Lease expense recognized* |  |  |  |  |
| Interest expense |  | $ (1,398) | $ (1,033) | $ (569) |
| Amortization expense |  | (12,667) | (12,667) | (12,666) |
| Total periodic expense |  | $ (14,065) | $ (13,700) | $ (13,235) |
| *Balance sheet* |  |  |  |  |
| Lease liability | $ (33,000) | $ (24,398) | $ (13,431) | $ — |
| Right-of-use asset | $ 38,000 | $ 25,333 | $ 12,666 | $ — |

|  |
| --- |
| *Analysis*: At lease commencement, Entity H would recognize the right-of-use asset and lease liability:  Right-of-use asset $ 38,000  Lease liability $ 33,000  Cash 5,000  *To initially recognize the right-of-use asset, lease liability and payment that qualifies as an IDC.*  The following journal entries would be recorded in Year 1:  Interest expense $ 1,398  Lease liability $ 1,398  *To record interest expense and accrete the lease liability using the interest method ($33,000 x 4.235%)*  Amortization expense $ 11,000  Right-of-use asset $ 11,000  *To record amortization expense on the right-of-use asset ($33,000 ÷ 3 years)*  Amortization expense for IDC $ 1,667  Right-of-use asset $ 1,667  *To record the amortization of the IDC ($5,000 ÷ 3 years)*  Lease liability $ 10,000  Cash $ 10,000  *To record lease payment*  A summary of the lease contract’s accounting (assuming no changes due to reassessment, lease  modification or impairment) is as follows:  Immaterial differences may arise in the recomputation of amounts in the example above due to rounding. |

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Illustratio**  i  This table operating (  Finance le  **Time** | **n 4-7: Comparing a**  llustrates the similaritie see Illustration 4-3) leas  ase:  **Lease liability** | **lessee’s accounting fo**  s and differences in acc es:  **Right-of-use asset** | **r finance leas**  ounting for fin  **Interest expense** | **es and operatin**  ance (see Illustr  **Amortization expense** | **g leases**  ation 4-6) and  **Total expense** |
| Initial | $ 33,000 | $ 38,000 |  |  |  |
| Year 1 | $ 24,398 | $ 25,333 | $ 1,398 | $ 12,667 | $ 14,065 |
| Year 2 | $ 13,431 | $ 12,666 | 1,033 | 12,667 | 13,700 |
| Year 3 | $ — | $ — | 569 | 12,666 | 13,235 |
|  |  |  | $ 3,000 | $ 38,000 | $ 41,000 |

|  |
| --- |
| Operating lease:  The initial measurement of the right-of-use asset and the lease liability is the same for finance and operating leases. Also, the same total lease expense is recognized over the life of the arrangement, but it is classified differently in the income statement and recognized at different times. A lessee generally recognizes higher periodic lease expense in the earlier periods of a finance lease than it does for an operating lease. |

## Master lease agreements

|  |  |  |  |
| --- | --- | --- | --- |
| **Time** | **Lease liability** | **Right-of use asset** | **Lease expense** |
| Initial | $ 33,000 | $ 38,000 |  |
| Year 1 | $ 24,398 | $ 25,731 | $ 13,667 |
| Year 2 | $ 13,431 | $ 13,097 | 13,667 |
| Year 3 | $ — | $ — | 13,666 |
|  |  |  | $ 41,000 |

Under a master lease agreement, a lessee may gain control over the use of additional underlying assets during the term of the agreement. In certain cases, a master lease agreement may specify a minimum number or value of underlying assets the lessee is required to obtain. For example, a lessee enters into an agreement to obtain the right to lease three floors of a building with an option to lease an additional floor (i.e., the fourth floor).

To the extent that a lessee is required to take a specified minimum quantity or value of the underlying assets, the lessee obtaining control over the use of those additional underlying assets is not a lease modification (i.e., a change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease). To identify the separate lease components and allocate the amount of consideration in the master lease agreement attributed to the additional underlying assets, the lessor applies the guidance in ASC 842-10-15-28 through 15-42 (refer to section 1.4, *Identifying and separating lease and non-lease components of a contract and allocating contract consideration*).

To the extent that additional underlying assets beyond the specified minimum are leased under the master lease agreement, the lessee obtaining control over the use of those additional underlying assets is considered a lease modification. Refer to section 4.6, *Lease modifications*, for the accounting of a lease modification.

If a master lease agreement does not include a specified minimum quantity or dollar value, the lessee obtaining control over the use any additional underlying asset is also considered a lease modification. Refer to section 4.6, *Lease modifications*, for the accounting of a lease modification.

## Remeasurement of lease liabilities and right-of-use assets — operating and finance leases

Lessees are required to remeasure finance and operating lease liabilities when there is a lease modification (i.e., a change to the terms and conditions of the contract that results in a change in the scope of or the consideration for the lease) that is not accounted for as a separate contract. Refer to section 4.6, *Lease modifications*.

Lessees are also required to remeasure finance and operating lease liabilities when any of the following occurs:

* A resolution of a contingency that is unrelated to a change in a reference index or rate and results in some or all of the payments allocated to the lease component that were previously determined to be variable meeting the definition of a lease payment (e.g., an event occurs that results in variable payments that were linked to the performance or use of the underlying asset becoming fixed payments for the remainder of the lease term)
* A change in any of the following:
  + The lease term (refer to section 2.3.1, *Lease term*)
  + The assessment of whether a lessee is reasonably certain to exercise an option to purchase the underlying asset (refer to section 2.3.2, *Purchase options*)
  + The amount it is probable the lessee will owe under a residual value guarantee (refer to section 2.4.6,

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

In these cases, a lessee remeasures the lease liability at the reassessment date and adjusts the right-of-use asset by the change in the lease liability. However, if the right-of-use asset is reduced to zero, a lessee recognizes any remaining amount in profit or loss. The FASB indicated in the Basis for Conclusions (BC 225) of ASU 2016-02 that a right-of-use asset that was previously reduced to zero could be remeasured to an amount greater than zero if a reassessment of the lease term or a lessee’s purchase option increases the lease liability. However, the FASB observed that a right-of-use asset would generally be measured at zero before the end of the lease term if it has been fully impaired (refer to section 4.2.5, *Impairment of right-of- use assets in operating leases*), and it would be unlikely that a lessee would reassess the lease term upward or conclude that it is reasonably certain to exercise an option to purchase the underlying asset when it has previously concluded the fair value of the right-of-use asset was fully impaired.

The discount rate is also revised at the remeasurement date based on the remaining lease term and lease payments unless the remeasurement of the lease liability is the result of one of the following:

* A change in the lease term or the assessment of whether the lessee will exercise an option to purchase the underlying asset and the discount rate for the lease already reflects that the lessee has an option to extend or terminate the lease or to purchase the underlying asset
* A change in the amount it is probable the lessee will owe under a residual value guarantee
* A resolution of a contingency that results in some or all of the lease payments that were previously determined to be variable meeting the definition of lease payments

The following chart provides an overview of the reassessment and remeasurement requirements applicable to lessees.

|  |  |  |  |
| --- | --- | --- | --- |
|  | **In remeasuring the ROU asset/lease liability, reassess the following:** | | |
| **Remeasurement of the lease liability and the ROU asset occurs when:** | **Measurement/ allocation of consideration,**  **lease payments1** | **Discount rate** | **Lease term and**  **classification** |
| A modification occurs that is not accounted for as a separate contract, and the modified contract is or contains a lease |  |  |  |
| A change in lease term results from a triggering event (e.g., a significant event or a significant change in circumstances within the lessee’s control, contractual event, option exercised, option not exercised) |  | 2 |  |
| The lessee changes its assessment of whether it is reasonably certain to exercise an option to purchase the underlying asset resulting from  a triggering event |  | 2 |  |
| A contingency is resolved that results in variable lease payments meeting the definition of lease payments |  |  |  |
| The lessee changes its assessment of amount owed under a residual value guarantee |  |  |  |

1 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 If the discount rate for the lease liability does not already reflect the lessee’s option in the lease to extend or terminate the lease or to purchase the underlying asset.

Refer to section 3.5.1, *Summary of lease reassessment and remeasurement requirements,* and section 4.6,

*Lease modifications,* for additional details*.*

## Lease modifications (updated August 2023)

If a lease is modified (i.e., a change to the terms and conditions of a contract that results in a change in the scope of or consideration for the lease), the modified contract is evaluated to determine whether it is or contains a lease (refer to section 1.3, *Reassessment of the contract*). If a lease continues to exist, a lease modification can result in:

* A separate contract (refer to section 4.6.2, Determining whether a lease modification is accounted for as a separate contract)
* A change in the accounting for the existing lease and not a separate contract (refer to section 4.6.3,

*Lessee accounting for a modification that is not accounted for as a separate contract*) Refer to section 4.6.1, S*ummary of the accounting for lease modifications — lessees*.

Examples of lease modification include 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. Additionally, a change to lease payments (regardless of whether they are fixed or variable) or a change in the timing of lease payments is a lease modification.

The exercise of an existing purchase or renewal option or a change in the assessment of whether such options are reasonably certain to be exercised is not a lease modification but can result in the remeasurement of lease liabilities and right-of-use assets. Refer to section 4.5*, Remeasurement of lease liabilities and right-of-use assets — operating and finance leases*.

### Summary of the accounting for lease modifications — lessees

No

Lease termination (ASC 842-20-40-1 and section 4.8.1, *Lease termination*)

**Is the modified contract a lease, or does it contain a lease?** (ASC 842-10-15-6; section 1.2, *Determining whether an arrangement contains a lease*; and section 1.3, *Reassessment of the contract*)

Yes

Yes

Account for two separate contracts:

* The unmodified original contract
* A separate contract, which is accounted for in the

same manner as any other new lease

(ASC 842-10-25-8 and section 4.6.2, *Determining whether a lease modification is accounted for as a separate contract*)

**Does the modification result in a separate contract?**

(ASC 842-10-25-8 and section 4.6.2, *Determining whether a lease modification is accounted for as a separate contract*)

No

|  |
| --- |
| * Remeasure and reallocate the remaining consideration in the contract * Reassess the classification of the lease at the effective date of the modification * Account for any initial direct costs, lease incentives and other payments made to or by the lessee   (ASC 842-10-25-9 through 25-12 and section 4.6.3, Lessee accounting for a modification that is not accounted for as a separate contract) |

No

**Does the modification fully or partially terminate an existing lease?** (ASC 842-10-25-11(c) and

section 4.6.3, *Lessee accounting for a modification that is not accounted for as a separate contract*)

Remeasure the lease liability and adjust the carrying amount of the right-of-use asset by the amount

of the remeasurement of the lease liability

(ASC 842-10-25-12 and section 4.6.3, *Lessee accounting for a modification that is not accounted for as a separate contract*)

Yes

Remeasure the lease liability and decrease the carrying amount of the right-of-use asset in proportion to the full or partial termination of the existing lease

and

Recognize in profit or loss any difference between the reduction in the lease liability and the reduction in the right-of-use asset (ASC 842-10-25-13 and section 4.6.3, *Lessee accounting for a modification that is not accounted for as a separate contract*)

|  |
| --- |
| **Was a finance lease modified and the modified lease classified as an operating lease?** (ASC 842-10-25-14 and section 4.6.3, *Lessee accounting for a modification that is not accounted for as a separate contract*) |

Yes No

Account for any difference between (1) the carrying amount of the right-of-use asset after recording

the adjustment required by

ASC 842-10-25-12 or ASC 842-10-25-13 and (2) the

carrying amount of the right-of-use asset that would result if the initial operating right-of-use asset measurement guidance in ASC 842-20-30-5 had been applied in the same manner as a rent prepayment or a lease incentive (ASC 842-10-25-14

and section 4.6.3, *Lessee accounting for a modification that is not accounted for as a separate contract*)

Apply the subsequent measurement guidance for the applicable classification

### Determining whether a lease modification is accounted for as a separate contract (updated August 2023)

A lessee accounts for a lease modification (i.e., a change to the terms and conditions of a contract that results in a change in the scope of or consideration for the lease) as a separate contract (i.e., separate from the original contract) when both of the following conditions are met:

* The modification grants the lessee an additional right of use that is not included in the original lease (e.g., a right to use an additional underlying asset).
* The lease payments increase commensurate with the standalone price for the additional right of use, adjusted for the circumstances of the particular contract.

If both of these conditions are met, the lease modification results in two separate contracts, the unmodified original contract and a separate new contract. Lessees account for the separate contract that contains a lease in the same manner as other new leases. Refer to Example 15 in ASC 842 that illustrates this concept in section 4.6.5, *Examples — lessees’ accounting for lease modifications*.

If both of the conditions are not met, the modified lease is not accounted for as a separate contract. Refer to section 4.6.3, *Lessee accounting for a modification that is not accounted for as a separate contract*.

The FASB indicated in the Basis for Conclusions (BC 176(a)) of ASU 2016-02 that the right to use an additional underlying asset (e.g., an additional floor of a building) will generally be a separate lease component, even if the modification granting that additional right of use does not create a separate contract (i.e., separate from the original contract). To illustrate, if an existing lease for a floor of a building is modified to include a second floor, the right to use the second floor will often be a separate lease component from the right to use the first floor, even if the second floor is not accounted for under a separate contract (e.g., because the increase in lease payments is not commensurate with the standalone price for the additional floor). Refer to section 1.4.1, *Identifying and separating lease components of a contract*, and Example 17 in ASC 842 that illustrates this concept in section 4.6.5, *Examples — lessees’ accounting for lease modifications*.

If the lease modification grants the lessee the right to use the existing underlying asset for an additional period of time (i.e., a period of time not included in the original lease agreement), the modified lease is not accounted for as a separate contract. In such cases, as indicated in the Basis for Conclusions (BC 176(b)) of ASU 2016-02, the modification only changes an attribute of the lessee’s existing right to use the underlying asset that it already controls. This is the case even if the extended term is priced at market. Refer to Example 16 in ASC 842 that illustrates this concept in section 4.6.5.2, *Modification increases or decreases the lease term*.

Question 4-2 When a modification both grants an additional right of use and includes other changes to existing rights and obligations, should the additional right of use be accounted for as a separate contract? (added August 2023)

A modification is accounted for as a separate contract if the only change to the contract is granting an additional right of use with increased lease payments that are commensurate with the standalone price for the additional right of use. If there are other changes to existing rights and obligations, the modification does not meet the criteria to be accounted for as a separate contract in accordance with ASC 842-10-25-8.

### Lessee accounting for a modification that is not accounted for as a separate contract (updated July 2024)

ASC 842 requires lessees to reassess whether a contract is or contains a lease when the terms and condition of a contract are changed. If the contract continues to be or contain a lease, the lessee will reassess lease classification at the effective date of a lease modification (i.e., the date that the lease modification is approved by both the lessee and the lessor) that is not accounted for as a separate contract. Lease classification is reassessed using the modified terms and conditions and the facts and circumstances as of that date, including:

* The remaining economic life of the underlying asset on that date
* The fair value of the underlying asset on that date
* The discount rate for the lease on that date
* The remeasured and reallocated remaining consideration in the contract on that date, which includes the remaining balance of any unamortized lease prepayments
* The remeasured lease term and assessment of any lessee options to purchase the underlying asset as of that date

The following provides an overview of the reassessment and remeasurement requirements applicable to lessees when a modified lease is not accounted for as a separate contract:

Lessees reassess the following upon a lease modification that is not accounted for as a separate contract:

**Lease classification**

**Discount rate**

**Measurement/allocation of consideration in the contract1**

**Lease term and purchase options**

1 Includes updating variable lease payments that depend on an index or rate as of the remeasurement date using the remeasurement date index or rate.

Lessees remeasure and reallocate the remaining consideration in the contract and remeasure the lease liability (using the discount rate determined at the effective date of the modification) for the following types of modifications:

|  |  |  |
| --- | --- | --- |
| **Type of modification** | **Remeasurement and reallocation requirement** | **Implementation guidance** |
| Grants the lessee an additional right of use that was not included in the original contract and the modification is not accounted for as a separate contract (refer to section 4.6.2, *Determining whether a modification is accounted for as a separate contract*) | ASC 842-10-25-12 requires the lessee to recognize the amount of the remeasurement of the lease liability as an adjustment to the corresponding right-of-use asset without affecting profit or loss.  The modified contract contains an additional separate lease component, to which the lessee allocates the lease payments based on the relative standalone price basis. | Refer to Example 17 in section 4.6.5.3, *Modification grants an additional right of use — not a separate contract*. |
| Extends or reduces the term of an existing lease (e.g., changes the lease term from five to eight years), other than through the exercise of a contractual option to extend or terminate the lease already included in the lease term | ASC 842-10-25-12 requires the lessee to recognize the amount of the remeasurement of the lease liability as an adjustment to the corresponding right-of- use asset without affecting profit or loss. However, if the right-of-use asset is reduced to zero, a lessee would recognize any remaining amount in profit or loss. Refer to section 4.5, *Remeasurement of lease liabilities and right-of-use assets — operating and finance leases*. | Refer to Example 16 in section 4.6.5.2, *Modification increases or decreases the lease term*. |

|  |  |  |
| --- | --- | --- |
| **Type of modification** | **Remeasurement and reallocation requirement** | **Implementation guidance** |
| Fully or partially terminates an existing lease immediately (e.g., reduces the assets subject to the lease) | For a modification that fully or partially terminates the existing lease (e.g., reduces the square footage of leased space),  ASC 842-10-25-13 requires a lessee to decrease the  carrying amount of the right-of- use asset in proportion to the full or partial termination of the lease. Any difference between those adjustments is recognized in profit or loss at the effective date of the modification. Refer to Example 18 in section 4.6.5, *Examples — lessees’ accounting for lease modifications*, and Illustration 4-8 below for an example of the accounting for a partial termination of a lease. | Refer to Example 18 in section 4.6.5.4, *Modification partially terminates a lease*. |
| Changes the consideration in the contract only | ASC 842-10-25-12 requires the lessee to recognize the amount of the remeasurement of the lease liability as an adjustment to the corresponding right-of- use asset without affecting profit or loss. However, if the right-of-use asset is reduced to zero, a lessee would recognize any remaining amount in profit or loss. Refer to section 4.5, *Remeasurement of lease liabilities and right-of-use assets — operating and finance leases*. | Refer to Example 19 in section 4.6.5.5, *Modification only changes lease payments*. |

Modified lease — lease classification changes

If a finance lease is modified and the modified lease is classified as an operating lease, any difference between the carrying amount of the right-of-use asset after recording the adjustment required by

ASC 842-10-25-12 or ASC 842-10-25-13 (discussed above) and the carrying amount of the right-of-use asset that would result from applying the initial operating right-of-use asset measurement guidance in ASC 842-20-30-5 (i.e., the amount of the lease liability, any lease prepayments less any lease incentives received and any initial direct costs incurred by the lessee) to the modified lease is accounted for in the same manner as a rent prepayment or a lease incentive.

Refer to Example 16, Case B in section 4.6.5.2, *Modification increases or decreases the lease term*, for an example of an operating lease that is modified and becomes a finance lease.

Modified lease – termination at a future date

In some cases, a lease may be modified to fully or partially terminate the lease at a future date (i.e., the termination does not take effect contemporaneously with the effective date of the modification). Questions have arisen about whether the guidance on full or partial terminations in ASC 842-10-25-11(c) and

ASC 842-10-25-13 applies to these modifications. We believe lease terminations that do not take effect contemporaneously with the effective date of the lease modification are effectively reductions in the lease term and a lessee should apply the guidance in ASC 842-10-25-11(b) and ASC 842-10-25-12. As discussed above, when a lease is modified to extend or reduce the term of an existing lease, a lessee recognizes the amount of the remeasurement of the lease liability for the modified lease as an adjustment to the corresponding ROU asset.

Initial direct costs

Lessees account for initial direct costs, lease incentives and any other payments made to or by the lessee in connection with the lease modification in the same manner as those items are accounted for in connection with a new lease. Refer to section 2, *Key concepts.*

|  |
| --- |
| **Illustration 4-8: Lessee partially terminates an existing lease** |
| On 1 January 20X0 Lessee entered into a 10-year lease with Landlord for retail space in an enclosed shopping mall. The retail store is 5,000 square feet.  On 1 April 20X2, Lessee and Landlord modified the contract to reduce the square footage of the leased space to 4,000 square feet from 5,000 square feet and to reduce the lease payments. No other terms of the lease were modified. Lessee appropriately accounted for the lease modification as a modification that is not accounted for as a separate contract.  On 1 April 20X2, immediately before the parties signed the modified lease agreement, Lessee had a remaining ROU asset of $100,000 for the lease and a lease liability of $120,000. Based on the terms of the modified lease agreement, the lease liability is $90,000, which reflects the early termination of the right to use 1,000 square feet of space, the remaining consideration in the contract (based on the decreased lease payments) and a discount rate for the lease determined at the effective date of the modification. The classification of the lease did not change as a result of the modification.  Lessee may decide to remeasure the ROU asset based on the change in lease liability or remaining right of use.  ***Scenario A — remeasuring the ROU asset based on change in lease liability***  The pre-modification ROU asset was $100,000. Lessee decreased the carrying amount of the ROU 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 difference between the pre-modification liability and the modified lease liability was $30,000 ($120,000 — $90,000). That difference is 25% ($30,000 ÷ $120,000) of the pre-modification lease liability.  Therefore, at the effective date of the modification, Lessee reduced the carrying amount of the ROU asset by $25,000 (25% × $100,000). Lessee recognized the difference between the adjustment to the lease liability and the adjustment to the ROU asset ($30,000 — $25,000 = $5,000) as a gain.  Lease liability $ 30,000 (a)  ROU asset $ 25,000 (b)  Gain from modification $ 5,000 (c)  (a) Difference between the pre-modification liability ($120,000) and the modified lease liability ($90,000).  (b) Reduction of ROU asset based on the percentage change in lease liability (remaining ROU asset of $100,000 x 25% change in lease liability).  (c) Difference between the reduction in the lease liability ($30,000) and the proportionate reduction in the ROU asset ($25,000). |

The following table illustrates the adjusted carrying values for the ROU asset and lease liability:

|  |  |  |  |
| --- | --- | --- | --- |
|  | **ROU asset** | **Lease liability** | **Gain** |
| Remaining carrying value prior to lease modification | $ 100,000 | $ 120,000 |  |
| Reduction in carrying value based on change in lease liability | (25,000) | (30,000) | $ 5,000 |
| Adjusted carrying value | $ 75,000 | $ 90,000 |  |

Scenario B — remeasuring the ROU asset based on the remaining right of use

Retailer decreased the carrying amount of the ROU asset by the same proportion as the decrease in square footage.

The difference in square feet leased between the pre-modification lease and the modified lease was 1,000 square feet (5,000 square feet — 4,000 square feet). That difference is 20% (1,000 square feet

÷ 5,000 square feet) of the pre-modification lease.

Therefore, at the effective date of the modification, Lessee reduced the carrying amount of the ROU asset by $20,000 (20% × $100,000) and reduced the carrying amount of the lease liability by

$24,000 (20% × $120,000). Lessee recognized the difference between the reduction in the lease liability and the reduction in the ROU asset ($24,000 — $20,000 = $4,000) as a gain.

Lease liability $ 24,000 (a)

ROU asset $ 20,000 (b)

Gain from modification $ 4,000 (c)

(a) Reduction of lease liability in proportion to the reduction of leased space (remaining lease liability of $120,000 x 20% reduction in space).

(b) Reduction of ROU asset in proportion to the reduction of leased space (remaining ROU asset of $100,000 x 20% reduction in space).

(c) Difference between the reduction in the lease liability ($24,000) and the reduction in the ROU asset ($20,000).

Lessee then recognized the $6,000 difference between the remaining lease liability of $96,000 ($120,000 lease liability immediately before the modification less the reduction of $24,000) and the modified lease liability of $90,000 as an adjustment to the ROU asset reflecting the change in the consideration paid for the lease and the revised discount rate. Retailer records the following entry:

Lease liability $ 6,000

ROU asset $ 6,000

The following table illustrates the adjusted carrying values for the ROU asset and lease liability:

|  |  |  |  |
| --- | --- | --- | --- |
|  | **ROU asset** | **Lease liability** | **Gain** |
| Remaining carrying value prior to lease modification | $ 100,000 | $ 120,000 |  |
| Reduction in carrying value in proportion to reduction in space | (20,000) | (24,000) | $ 4,000 |
| Adjusted carrying value (prior to remeasurement of lease liability) | $ 80,000 | $ 96,000 |  |
| Change in consideration paid for the lease (and revised discount rate) | (6,000) | (6,000) |  |
| Adjusted carrying value | $ 74,000 | $ 90,000 |  |

* + - 1. **Lessee accounting for a modification due to reference rate reform (updated August 2023)**

|  |
| --- |
| **Note**  In January 2021, the FASB issued ASU 2021-01, *Reference Rate Reform (Topic 848): Scope*, to clarify that all derivative instruments affected by changes to the interest rates used for discounting, margining or contract price alignment due to reference rate reform are in the scope of ASC 848. The ASU does not amend the guidance in ASC 842 or affect the optional expedient provided to lessees by ASC 848 to not apply certain modification accounting requirements to contracts affected by reference rate reform. |

ASC 848, *Reference Rate Reform*, provides temporary optional expedients and exceptions to the US GAAP guidance on contract modifications to ease the financial reporting burden related to the expected market transition from LIBOR and other interbank offered rates to alternative reference rates, such as SOFR.

Under ASC 842, a lease modification is a change to the terms and conditions of a contract that results in a change in the scope of or consideration for the lease. Therefore, a change in the index or rate on which lease payments are dependent would be accounted for as a lease modification because it will result in a change in the consideration for the lease. A lease modification generally requires the remeasurement and reallocation of consideration in the contract; reassessment of lease term, discount rate and lease classification; and, for lessees, remeasurement of the ROU asset and lease liability. Refer to section 4.6, *Lease modifications*, for further discussion of the accounting for lease modifications by lessees.

However, the guidance in ASC 848 provides entities with an optional expedient to not apply certain modification accounting requirements to contracts affected by reference rate reform, if certain criteria are met. If a modified lease contract meets the following required criteria and the entity elects to apply the optional expedient in ASC 848, the entity would not account for the change in the lease contract as a lease modification:

* The lease contract references LIBOR or another rate that is expected to be discontinued due to reference rate reform.
* The modified terms of the lease contract directly replace or have the potential to replace the reference rate that is expected to be discontinued due to reference rate reform.

If contemporaneous changes are made to other terms in the contract that change or have the potential to change the amount or timing of contractual cash flows, the optional expedient may only be applied if those changes are related to the replacement of the reference rate. For example, a change to the lease

term concurrent with the change in the rate in which lease payments are dependent would disqualify an entity from applying the relief from modification accounting to that lease; the change in lease term changes the amount and timing of cash flows in the lease and is unrelated to the change in the rate in the lease due to reference rate reform.

If an entity elects the optional expedient, it must apply it consistently for all eligible modified leases accounted for under ASC 842.

The guidance was effective upon issuance in March 2020. The guidance on contract modifications is applied prospectively from any date beginning 12 March 2020. It may also be applied to modifications of existing contracts made earlier in the interim period that includes the effective date (i.e., modifications made as early as 1 January 2020 for a calendar-year company). The relief is temporary and generally cannot be applied to contract modifications that occur after 31 December 2024. Entities that elect the relief are required to disclose the nature of the optional expedients and exceptions they are applying and their reasons for doing so.

### Lease modifications in connection with the refunding of tax-exempt debt

Tax-exempt debt is often issued by a governmental or quasi-governmental authority to finance the construction of a facility such as a plant or a hospital. The user of the facility either buys the facility or leases it from the authority. The mortgage note or the lease serves as collateral for the tax-exempt debt, and the amount and timing of payments on the note or lease are the same as the debt service requirements of the tax-exempt debt. Often, in the case of a lease, title passes at the end of the lease term, thereby meeting one of the criteria for classification as a finance lease.

Many tax-exempt organizations have entered into a refunding by replacing the old debt with new debt to obtain an economic advantage (e.g., lower interest costs) for the lessee or mortgagor. As a result of the refunding, the terms of the related mortgage note or lease are changed to conform with the terms of the new debt issued.

Refundings of tax-exempt debt transactions when the property is leased to the user are accounted for by the user in the same manner as any other lease modification. Refer to section 4.6.2, *Determining whether a lease modification is accounted for as a separate contract,* and section 4.6.3, *Lessee accounting for a modification that is not accounted for as a separate contract,* for further discussion of the accounting for lease modifications by lessees.

### Examples — lessees’ accounting for lease modifications

##### Modification is accounted for as a separate contract

##### Modification increases or decreases the lease term (updated August 2023)

The following example illustrates a lessee’s accounting for a modified lease that decreases the term of the lease.

|  |
| --- |
| **Illustration 4-9: Modification that decreases lease term and change in lease classification** |
| Lessee and Lessor enter into a 15-year lease for a piece of equipment with a remaining economic life of 17 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 a finance lease. At the beginning of Year 6, Lessee and Lessor agree to modify the lease such that the total lease term decreases from 15 years to 8 years. The annual lease payments increase to $110,000 per year for the remaining 3 years after the modification. Lessee’s incremental borrowing rate is 7 percent at the date the modification is agreed to by the parties.  On the modification date, the Lessee classifies the lease as an operating lease as the remaining lease term of 3 years is not a major part of the 12-year remaining economic life of the equipment and no other lease classification criteria are met. The Lessee remeasures its lease liability based on the three- year remaining lease term, three remaining payments of $110,000, and its incremental borrowing rate of 7 percent. The modified lease liability equals $288,675. The decrease to the lease liability of  $447,334 is recorded as an adjustment to the right-of-use asset (i.e., there is no income or loss effect from the modification because, in this example, the right-of-use asset is not reduced below zero). |

##### Modification grants an additional right of use — not a separate contract

##### Modification partially terminates a lease

##### Modification only changes lease payments

### Relocating from one leased space to another leased space with the same landlord

A lessee that immediately terminates an existing contract and enters into a new lease arrangement for a different underlying asset with a different unrelated landlord generally should account for the change as a termination of the existing lease in accordance with ASC 842-20-40-1 (i.e., by removing the ROU asset and the lease liability from the balance sheet and recognizing the difference between the ROU asset and the lease liability in profit or loss) and the execution of a new lease. Refer to section 4.8.1, *Lease termination*, for further discussion of lease terminations and section 4.6.3, *Lessee accounting for a modification that is not accounted for as a separate contract*, for further discussion of lease modifications that reduce the term of an existing lease instead of immediately terminating the lease.

A lessee that immediately terminates an existing lease and contemporaneously enters into a new lease arrangement (i.e., the new lease would not be executed and the existing lease would not be terminated without the other) for a substantively different underlying asset with the same landlord (or a related party of the landlord) generally should account for the change as a termination of the existing lease by removing the ROU asset and the lease liability from the balance sheet. We believe any difference between the ROU asset and the lease liability is included as part of the ROU asset of the new lease upon initial recognition, similar to a lease incentive or initial direct cost of the new lease. That is because ASC 842-10-25-19 states that an entity should 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 the contracts are negotiated as a package with the same commercial objective(s).

A retailer that relocates from one leased space to another leased space should also consider the accounting effects of that change on any long-lived assets (e.g., leasehold improvements) at the old space. That is, a retailer that intends to abandon long-lived assets when it relocates to another space should determine whether its depreciation estimates must be revised (in accordance with the change in estimate guidance in ASC 250) and whether the corresponding asset group is impaired (in accordance with ASC 360-10). A decision to abandon long-lived assets is generally an indicator of impairment.

The following example illustrates the lessee’s accounting for relocating from one leased space to a smaller leased space with the same landlord, and the new lease would not be executed and the existing lease would not be terminated without the other (i.e., the two contracts with the same counterparty are combined in accordance with ASC 842). The accounting treatment would be similar if the lessee relocated from one leased space to a larger leased space with the same landlord, and the new lease would not be executed and the existing lease would not be terminated without the other.

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| **Illustration 4-10: Relocating from one leased space to another leased space with the same landlord** |
| On 1 January 20X0, Retailer (lessee) entered into a 10-year operating lease with Landlord for retail store A in an enclosed shopping mall. Retail store A is 10,000 square feet. The lease requires Retailer to make fixed monthly payments at the beginning of each month, but the amount increases each year. There are no initial direct costs or incentives associated with the lease, and there are no non-lease components in the contract.  On 1 January 20X2, Retailer and Landlord negotiate a new contract to immediately terminate the lease for retail store A and contemporaneously enter into a new lease for retail store B (i.e., the termination of the retail store A lease is dependent on the execution of the new retail store B lease). Retail store B is 5,000 square feet and is located in a more desirable location in the same shopping mall that Retailer believes will help increase foot traffic. The term of the new lease is eight years, consistent with the remaining term of the retail store A lease. There are no lease termination payments for retail store A, and no lease prepayments, initial direct costs or lease incentives associated with the retail store B lease. Also, there are no non-lease components in the contract.  On 1 January 20X2, immediately before the parties signed the new lease agreement, Retailer has a remaining ROU asset of $115,000 and a lease liability of $120,000. For simplicity, also assume the asset group that includes the ROU asset and leasehold improvements for retail store A are not impaired.  Based on the terms of the retail store B lease agreement, the initial measurement of the lease liability is $70,000, which represents the lease payments in the new lease, discounted using Retailer’s incremental borrowing rate at the commencement date of the new lease.  ***Analysis***  Retailer first needs to consider whether any leasehold improvements at retail store A will be abandoned and, if so, revise their useful lives and depreciation estimates.  Retailer then accounts for the change as a termination of the existing lease of retail store A by removing the ROU asset and the lease liability from the balance sheet and including any difference between the ROU asset and the lease liability as part of the ROU asset it recognizes related to the new lease of retail store B (which in this case is similar to a lease incentive received to enter into the retail store B lease). Retailer records the following entry:  Lease liability (existing lease) $ 120,000 (a)  ROU asset (existing lease) $ 115,000 (a)  ROU asset (new lease) 65,000 (b)  Lease liability (new lease) 70,000 (c)   1. Removal of remaining lease liability ($120,000) and ROU asset ($115,000) associated with existing lease of retail store A. 2. Recognition of ROU asset associated with the new lease of retail store B ($70,000) less the difference between the lease liability and ROU asset from retail store A lease ($5,000) (which in this case is similar to a lease incentive received to enter into the retail store B lease). 3. Recognition of lease liability associated with the new lease for retail store B. |

## Lease incentives and improvements

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

Payments made to or on behalf of the lessee represent incentives that the lessee should consider reductions of the right-of-use asset and rental expense over the term of the lease (refer to section 4.2.3, *Expense recognition — operating leases,* and section 4.3.3, *Expense recognition — finance leases,* for further discussion). Similarly, losses incurred by the lessor as a result of assuming a lessee’s preexisting lease with a third party should be considered an incentive by the lessee. Incentives should be recognized on a straight-line basis over the term of the lease. The lessee should independently estimate any loss attributable to the assumption of a preexisting lease with a third party. For example, the lessee’s estimate of the incentive could be based on a comparison of the lease with the market rental rate available for similar lease property or the market rental rate from the same lessor without the lease assumption. Refer to section 2.4.1.2, *Lease incentives*, for further discussion of lease incentives.

### Whether improvements are lessee or lessor assets

Entities should evaluate whether improvements made to the underlying asset are lessee or lessor assets because the determination affects whether a lessor payment to the lessee for the improvements is a lease incentive or a reimbursement of the costs incurred by the lessee (refer to section 2.11, *Improvements to the underlying asset*, for factors to consider). For example, if a retailer leases general purpose retail space and has its own contractor build specific improvements to make the store look like the others it operates around the Country (i.e., the improvements are lessee assets), any amounts the lessor provides to pay a portion of the cost will generally be viewed as an incentive.

### Lessee involvement in asset construction (‘build-to-suit’ lease transactions)

Build-to-suit lease transactions involve various forms of lessee involvement in the construction of an asset for the lessee’s own use. The guidance in ASC 842 focuses on whether the lessee controls the asset being constructed rather than whether the lessee takes on risks during the construction period. Under ASC 842, if the lessee controls the asset during construction, the asset is capitalized as construction-in-progress and is subject to the sale and leaseback guidance at the end of construction.

Refer to section 7.7.2, *Determining whether the lessee controls the underlying asset being constructed*, and section 7.2, *Determining whether the transfer of an asset is a sale*, on the accounting for sale and leaseback transactions.

### Amortization of leasehold improvements

ASC 842 requires lessees to amortize leasehold improvements over the shorter of the following:

* The useful life of those leasehold improvements
* The remaining lease term

However, if the lease transfers ownership of the underlying asset to the lessee or the lessee is reasonably certain to exercise an option to purchase the underlying asset, leasehold improvements are amortized over their useful life.

The accounting for the amortization of leasehold improvements should be consistent with the lease term.

##### Leasehold improvements placed in service subsequent to lease commencement

As discussed in ASC 842-10-35-1 (refer to section 2.3.6, *Reassessment of the lease term and purchase options*), a lessee is required to monitor events that could trigger a change in the lease term. One example would be a lessee’s construction of significant leasehold improvements (e.g., in the eighth year of a 10-year lease) that are expected to have significant economic value for the lessee when a renewal option becomes exercisable. Regardless of when they are constructed, leasehold improvements should be amortized over the lesser of the remaining useful life of the asset(s) or the remaining lease term after reassessment in accordance with ASC 842-10-35-1. However, if the lease transfers ownership of the underlying asset to the lessee, or the lessee is reasonably certain to exercise an option to purchase the underlying asset, the lessee should amortize the leasehold improvements to the end of their useful life. This treatment is consistent with the guidance for leasehold improvements acquired in a business combination (refer to section 4.7.3.2, *Leasehold improvements acquired in business combinations*).

For example, Retailer A enters into a 10-year lease with a five-year renewal option. At the commencement date of the lease, Retailer A determined that the lease term was 10 years (i.e., it determined that it was not reasonably certain to exercise the five-year renewal option). Leasehold improvements placed in service at or near the commencement date of the lease are amortized over the shorter of their useful life or 10 years. In year eight, the retailer remodels the store and adds extensive leasehold improvements.

Retailer A reassesses the lease term and determines that it is now reasonably certain that it will exercise the five-year renewal option, and the remaining lease term is now seven years. Retailer A would amortize the leasehold improvements added in year eight over the shorter of their useful life or seven years

(i.e., the revised remaining lease term consists of two remaining years of the original lease term plus five

additional years related to the renewal option). The lessee would also reassess the amortization period for those leasehold improvements placed into service at or near commencement of the lease, which in the example above was the original 10-year term.

Judgment is required to analyze the facts, including the nature of the expenditures, to determine whether reassessment of the lease term is required and what the appropriate amortization period is. Refer to section 4.5, *Remeasurement of lease liabilities and right-of-use assets — operating and finance leases*, for further discussion of a lessee’s accounting for a lease when it reassesses the lease term.

##### Leasehold improvements acquired in business combinations

A leasehold improvement acquired in a business combination is similar to a leasehold improvement placed in service after the commencement date of a lease (as described in section 4.7.3.1, *Leasehold improvements placed in service subsequent to lease commencement*) and, as such, the asset should be amortized over the shorter of the useful life or the lease term (determined at the date the business combination is recorded) that includes renewals that are reasonably certain to be exercised. However, if the lease transfers ownership of the underlying asset to the lessee, or the lessee is reasonably certain to exercise an option to purchase the underlying asset, the lessee will amortize the leasehold improvements to the end of their useful life. Refer to section 4.4.4.4.4, *Acquired leasehold improvement*, of our FRD, [***Business combinations***](https://www.ey.com/en_us/technical/accountinglink/financial-reporting-developments---business-combinations).

###### Leasehold improvements acquired in asset acquisitions

In a circumstance where an entity acquires a land lease (as a lessee) and related existing leasehold improvements (e.g., a commercial building on leased land, which is commonly called a leasehold interest by real estate entities) in an asset acquisition rather than a business combination, we believe it is appropriate to treat the asset acquired as a leasehold improvement placed in service at or near lease commencement (the accounting described in section 4.7.3.1, *Leasehold improvements placed into service subsequent to lease commencement*). Also, refer to Appendix A, *Accounting for asset acquisitions*, of our FRD, [***Business combinations***](https://www.ey.com/en_us/technical/accountinglink/financial-reporting-developments---business-combinations), for additional discussion on the accounting for asset acquisitions.

###### Fresh start accounting for leasehold improvements

In general, the accounting for leasehold improvements that have been revalued in fresh start accounting should follow the guidance for business combinations noted in section 4.7.3.2, *Leasehold improvements acquired in business combinations*. This is because when an entity emerges from a Chapter 11 bankruptcy and applies fresh-start accounting, ASC 852, *Reorganizations*, requires the emerging entity to apply the business combination guidance in ASC 805, *Business Combinations*, and generally measure assets and liabilities at fair value. Refer to section 4.2, *Method for applying fresh-start accounting*, of our FRD, [***Bankruptcies, liquidations and quasi-reorganizations***](https://www.ey.com/en_us/technical/accountinglink/financial-reporting-developments-bankruptcies-liquidations-and-quasi-reorganizations), for more guidance on fresh-start accounting.

##### Salvage values

The amortization of leasehold improvements should take into account any net salvage value that would accrue to the lessee.

##### Lessee amortization of leasehold improvements associated with a lease between entities under common control (added August 2023)

All lessees, including public business entities, in a lease with a lessor under common control are required to:

* Amortize leasehold improvements over their useful life to the common control group, as long as the lessee controls the use of the underlying asset through a lease
* Account for the leasehold improvements as a transfer of assets between entities under common control through an adjustment to equity (or net assets for not-for-profit entities) when the lessee no longer controls the use of the underlying asset

If after the commencement date the lessee and lessor become part of the same common control group or stop being part of the same common control group, the lessee would account for any change in the required amortization period for leasehold improvements prospectively as a change in accounting estimate under ASC 250, *Accounting Changes and Error Corrections*.

Lessees are also required to apply the impairment guidance in ASC 360-10-40-4 to leasehold improvements associated with common control leases so that leasehold improvements are not immediately impaired after they are transferred to the entity under common control at the end of the lease term. Refer to section 4.10, *Disclosure*, for the related disclosure requirements.

## Other lessee matters

### Lease termination

An immediate termination of a lease (operating or finance) before the expiration of the lease term is accounted for by derecognizing the lease-related asset and liability. Any consideration paid or received upon termination that was not already included in the lease payments (e.g., a termination penalty that was not included in lease payments based on the lease term) is included in the gain or loss on termination of the lease.

When the parties agree that a lease will be terminated before the expiration of the lease term but the termination will be effective at a future date (i.e., a lessee does not immediately cease using the underlying asset), the change to the lease is generally accounted for as a lease modification that shortens the lease term rather than a lease termination. This type of modification can occur if a termination is agreed to but the lessee is given a month to move out, for example. See section 4.6.3, *Lessee accounting for a modification that is not accounted for as a separate contract*, for guidance on modifications that shorten the lease term.

If there is an ongoing arrangement between the lessee and the lessor that will arise in conjunction with the termination of a lease (e.g., a lease is reevaluated based on a change in the contractual terms and is determined to be a service contract), we believe the lessee would consider the net asset or liability associated with the lease in the measurement of the remaining arrangement.

ASC 405-20-40-1 provides guidance for determining when a liability (including a lease liability) has been extinguished and therefore can be removed from the obligor’s (lessee’s) balance sheet. A lease liability is considered extinguished (and a gain or loss is recognized) if either of the following two conditions is met:

* The lessee pays the lessor and is relieved of its obligation for the liability. Paying the lessor includes delivery of cash or other consideration.
* The lessee is legally released from being the primary obligor under the liability, either by a judicial body or by the lessor.

Some sale and assumption agreements may have other components that need to be accounted for. For example, a lessor might release a lessee as primary obligor on the condition that a third party assumes the obligation and that the original lessee becomes secondarily liable. While the release extinguishes the original lessee’s liability as the primary obligor, the lessee becomes a guarantor, regardless of whether consideration was paid for the guarantee. As a guarantor, the original lessee will recognize a guarantee obligation at fair value (under ASC 460) in the same manner as a guarantor that had never been primarily liable to that lessor. Refer to section 6, *Subleases*, for further discussion of accounting for subleases.

Under ASC 460, recognition of the guarantee would take into consideration the likelihood that the new primary obligor will fulfill its obligation. For example, if the new primary obligor had little substance and, therefore, would be unable to honor its obligation, the guarantor of that obligation would have to recognize a fair value liability that would likely not differ significantly from the obligation that would be recorded if it were still the primary obligor because of the inability of the new primary obligor to fulfill its obligation. Additionally, the guarantee obligation, initially measured at fair value, reduces the gain or increases the loss recognized from the extinguishment.

Under ASC 405-20-55-3 through 55-4, an “in-substance defeasance” transaction (e.g., when the underlying assets and the related obligations are transferred to a trust) does not meet the derecognition criteria for either the asset or the liability because of the following:

* The lessee is not released from the obligation by putting assets in a trust. For example, if the assets in a trust prove insufficient because a default by the lessee accelerates its obligation, the lessee is obligated to make the lessor whole.
* The lessor is not limited to the cash flows from the assets in trust.
* The lessor does not have the ability to dispose of the assets at will or to terminate the trust.
* If the assets in the trust exceed what is necessary to meet scheduled lease payments, the lessee can remove the excess.
* The lessee does not surrender control of the benefits of the assets because those assets are still being used for the lessee’s benefit to extinguish its liability. Because no asset can be an asset of more than one entity, those benefits must still be the lessee’s assets.

### Purchase of an underlying asset during the lease term

A lease termination does not include the lessee purchasing the underlying asset. Instead, the difference between the purchase price and the carrying amount of the lease liability is recorded as an adjustment to the carrying amount of the purchased asset. This guidance does not apply to underlying assets acquired in a business combination, which are initially measured at fair value. Refer to section 8, *Business combinations*.

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| **Illustration 4-11: Accounting for the purchase of an underlying asset during the term of a lease** |
| Entity X (lessee) has just completed the third year of a five-year finance lease agreement. The right-of- use asset has a net book value of $3,000, and the lease liability is $2,000. If the lease were terminated at the end of year three because the lessee purchased the underlying asset for $1,500, Entity X would record the following entry:  Lease liability $ 2,000  Fixed assets 2,500  Right-of-use asset $ 3,000  Cash 1,500  The right-of-use asset is reclassified as an owned asset, and the carrying amount of the owned asset ($3,000) is adjusted by the difference between the carrying value of the lease liability ($2,000) and the consideration paid ($1,500). |

### Leases denominated in a foreign currency

Lessees apply ASC 830, *Foreign Currency Matters*, to leases denominated in a foreign currency. As they do for other monetary liabilities, lessees remeasure a foreign currency-denominated lease liability using the exchange rate at each reporting date. Any changes to the lease liability due to exchange rate changes are recognized in profit or loss. Because the right-of-use asset is a nonmonetary asset measured at historical cost, it is remeasured using the exchange rate as of the lease commencement date and is not affected by subsequent changes in the exchange rate. Therefore, the subsequent measurement of the right-of-use asset will not equal the lease liability for operating leases denominated in a foreign currency.

The FASB acknowledged in the Basis for Conclusions (BC 247) of ASU 2016-02 that this approach could result in volatility in profit or loss from the recognition of foreign currency exchange gains or losses but believed it would be clear to users of financial statements that the gains or losses result solely from changes in exchange rates.

Questions have arisen regarding what foreign exchange rate a lessee should use to remeasure a right-of-use asset into the lessee’s functional currency upon a reassessment event or a modification that is not accounted for as a separate contract. As described in section 4.5, *Remeasurement of lease liabilities and right-of-use assets — operating and finance leases*, a lessee is required to remeasure a right-of-use asset (and lease liability) when there is a lease modification that is not accounted for as a separate contract. Lessees are also required to remeasure a right-of-use asset (and lease liability) when any of the following occur:

1. There is a change in lease term
2. There is a change in the assessment of whether a lessee is reasonably certain to exercise an option to purchase the underlying asset
3. There is a change in the amount it is probable the lessee will owe under a residual value guarantee
4. A resolution of a contingency that is unrelated to a change in a reference index or rate and results in some or all of the payments allocated to the lease component that were previously determined to be variable meeting the definition of a lease payment

In response to a technical inquiry, the SEC staff said it would not object to a lessee making an accounting policy election to either:

* + Remeasure the *entire* right-of-use asset using the exchange rate on the date of modification (that is not accounted for as a separate new lease) or, if the lease is remeasured for a reassessment event listed in (1) or (2) above, using the exchange rate on the date of reassessment. If the lease is remeasured for a reassessment event listed in (3) or (4) above, a lessee should remeasure the entire right-of-use asset using the historical exchange rate (i.e., it does not update the exchange rate for any portion of the right-of-use asset).
  + Remeasure only the portion of the right-of-use asset that was added as a result of the modification (that is not accounted for as a separate lease) or reassessment event using the exchange rate on the date of modification or reassessment.

The SEC staff said a lessee should apply its accounting policy election consistently to all leases and should disclose its accounting policy, if material. This view should not be applied by analogy to other nonmonetary assets or nonmonetary liabilities.

### Portfolio approach

ASC 842 applies to individual leases. However, entities that have a large number of leases of similar assets (e.g., leases of a fleet of similar railcars) may face practical challenges in applying the leases model on a lease-by-lease basis. The FASB acknowledged these concerns and said in the Basis for Conclusions (BC 120) of ASU 2016-02 that an entity can use a portfolio approach when “the entity reasonably expects that the application of the leases model to the portfolio would not differ materially from the application of the leases model to the individual leases in that portfolio.” For example, applying a portfolio approach to four-year leases of new automobiles of the same make and model, entered into in the same month with the same terms and conditions, may not differ materially from applying ASC 842 to the individual leases in the portfolio.

ASC 842 does not define “reasonably expects” and “materially.” The FASB also said in the Basis for Conclusions (BC 120) of ASU 2016-02 that “an entity would need to apply judgment in selecting the size and composition of the portfolio” and “it did not intend for an entity to quantitatively evaluate each outcome but, instead, that the entity should be able to take a reasonable approach to determine the portfolios that would be appropriate for its types of leases.”

The FASB also said in the Basis for Conclusions (BC 121) of ASU 2016-02 that “the cost relief offered by applying the leases guidance at a portfolio level need not be limited to simply grouping contracts together.” The portfolio approach could also be applied to other aspects of the leases guidance for which lessees need to make judgments and estimates, such as determining the discount rate and determining and reassessing the lease term.

ASC 842 provides the following implementation guidance for applying the portfolio approach to establish the discount rate for the lease.

### Effects of lease-related assets and liabilities on income tax accounting

ASC 842 also affects lessees’ accounting for income taxes. For lessees, ASC 842 requires recognition of additional lease-related assets and liabilities that will likely result in additional book-tax basis differences such as the following:

* Recognition and measurement of deferred tax assets and liabilities associated with book-tax basis differences
* Assessment of the realizability of deferred tax assets (i.e., the need for a valuation allowance) Refer to our FRD, [***Income taxes***](https://www.ey.com/en_us/technical/accountinglink/financial-reporting-developments---income-taxes-).

### Rent capitalization

A lessee is prohibited from capitalizing rent under an operating lease as part of the cost of a constructed asset. Rental costs incurred during and after a construction period are for the right to direct the use of an underlying asset during and after construction of a lessee asset. There is no distinction between the right to use an underlying asset during the construction period and the right to use that asset after the construction period. Therefore, lease costs associated with ground or building operating leases that are incurred during a construction period are recognized in accordance with ASC 842’s guidance for lessee accounting for operating leases (refer to section 4.2, *Operating leases*). Interest related to a finance lease should be included in the interest cost used to determine capitalized interest in accordance with ASC 835-20.

The guidance in ASC 842-10-55-21 does not address whether a lessee of real estate under development within the scope of ASC 970-360 should capitalize rental costs associated with ground and building operating leases during development. Refer to section 2.2.2, *Rental costs incurred during a construction period*, of our FRD, [***Real estate project costs***](https://www.ey.com/en_us/technical/accountinglink/financial-reporting-developments-real-estate-project-costs), for further discussion on accounting for such costs.

It should be noted that it is not appropriate to defer occupancy costs as a component of startup activities (ASC 720-15).

### Lessee accounting for maintenance deposits

Under certain lease arrangements, a lessee may be contractually or legally responsible for repair and maintenance of the leased asset during the term of the lease arrangement. In addition, the lease arrangement may require the lessee to make deposits (also commonly referred to as maintenance reserves or supplemental rent) with the lessor to protect the lessor if the lessee does not properly maintain the leased asset (i.e., the lessor would use the funds to restore the leased asset to proper working order).

Under a typical lease arrangement, the lessor is contractually required to reimburse the lessee a portion of the deposit as qualifying maintenance activities are performed and paid for by the lessee. If the deposits paid to the lessor exceed costs incurred for maintenance activities, the lease arrangement may allow the lessor to retain the excess amounts when the lease expires or may require the lessor to refund such excess amounts to the lessee. While refundable maintenance deposits are accounted for by lessees as a deposit, some had questioned the accounting for lessee maintenance deposits that are not automatically refundable in all instances, including those that are not refunded if the lessee does not perform the maintenance activities specified by the lease arrangement.

Maintenance deposits paid by the lessee under an arrangement accounted for as a lease that are refunded only if the lessee performs specified maintenance activities should be considered deposit assets by the lessee if it is probable that the deposits will be refunded. The cost of maintenance activities should be expensed or capitalized by the lessee, as appropriate, when the underlying maintenance is performed. If a lessee determines that it isn’t probable that its maintenance deposit will be refunded, the deposit is recognized as variable rent expense. If it is probable at inception of the lease that a portion of the deposits will not be refunded, the lessee should recognize as an expense a pro rata portion of the deposits as they are paid as variable lease payments (refer to section 2.9.1, *Lessee accounting for variable lease payments*).

Some lease agreements call for maintenance deposits and refunds to be made throughout the term of the lease. For instance, an airplane lease may require the lessee to make a deposit with the lessor based on usage of the airplane (e.g., pay a defined amount for every hour or cycle flown) and the lessor to refund those deposits upon the performance of required maintenance activities. In such leases, deposits can be made and refunded multiple times over the lease. The following illustration depicts the accounting treatment for multiple cycle maintenance deposits.

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| **Illustration 4-12: Deposits in leases with multiple maintenance cycles** |
| Airline A leases an airplane from Lessor B for 10 years and agrees to provide Lessor B with maintenance deposits of $50 for every flight hour flown. Airline A is responsible for maintaining the airplane, and Lessor B must reimburse Airline A for engine overhaul maintenance costs incurred up to the amounts on deposit when the engine overhaul maintenance occurs. Any excess amounts on deposit are retained by Lessor B.  Assume that the airplane being leased requires engine overhaul maintenance after every 20,000 flight hours, and the expected cost of the engine overall maintenance exceeds the amounts to be placed on deposit (i.e., expected cost of engine overhaul is greater than $1,000,000 = $50/hour x 20,000 hours). Airline A expects to fly the leased airplane between 4,000 and 5,000 hours each year.  In the early periods of the lease, deposits made by Airline A are probable of being returned because Airline A expects to incur reimbursable maintenance costs by performing engine overhaul maintenance. As such, maintenance deposits made should be accounted for as deposit assets.  Toward the end of the lease, Airline A may be required to make maintenance deposits that are not probable of being returned if Airline A does not expect to perform another engine overall. For instance, assume that Airline A flies the airplane for a total of 40,000 hours over the first nine years of the lease, performs the second engine overhaul at the end of the ninth year and receives reimbursement from Lessor B for the funds on deposit. Airline A would still be required to make payments of $50 for every flight hour flown in the 10th year of the lease. However, because Airline A will not perform another engine overhaul, those payments will not be returned (i.e., not probable of being returned). As such, the maintenance deposit payments made by Airline A after the second engine overhaul would not be considered deposit assets (as they are less than probable of being returned to Airline A) and should be accounted for as variable lease payments. |

To determine whether it is probable that the deposit will be refunded, entities should use the definition of probable in the ASC Master Glossary, which states that “the future event or events are likely to occur.” This is the same threshold of probability that is used in ASC 450 with respect to loss contingencies.

### Lessee accounting for costs to prepare an asset for its intended use or to deliver the asset to the location of its intended use

A lessee may incur certain costs to prepare an asset for its intended use or to deliver the asset to the location of its intended use. Questions have arisen about how a lessee accounts for such costs when paid to a third party (other than the lessor) or when the lessee performs the work itself.

In response to a technical inquiry, the FASB staff said that such costs are not initial direct costs because they do not represent costs incurred prior to lease inception that are directly attributable to negotiating and arranging a lease (refer to section 2.6, *Initial direct costs*). However, the FASB staff believes if no other GAAP applies to such costs, it would be permissible for a lessee to make an accounting policy election to analogize to the guidance in ASC 360-10 on accounting for costs to bring an asset to the condition and location necessary for its intended use or to expense the costs as incurred. A lessee should apply its accounting policy election consistently to all leases and should disclose its accounting policy, if material. A lessee that analogizes to the guidance in ASC 360-10 capitalizes such costs if the activities are consistent with the ASC 360-10 glossary definition of activities necessary to bring an asset to the condition and location necessary for its intended use. In a speech,9 a member of the SEC staff reiterated the views expressed by the FASB staff.

Note that the FASB technical inquiry did not address costs paid to the lessor. Those costs are accounted for as consideration in the contract (refer to section 1.4.3.1, *Determining the consideration in the contract — lessees*) or as part of a variable payment not based on an index or rate (refer to section 2.9.1, *Lessee accounting for variable lease payments*).

### Capitalization thresholds

Consistent with the discussion in the Basis for Conclusions (BC 122) of ASU 2016-02, we expect that entities may adopt a reasonable capitalization threshold below which ROU assets and lease liabilities will not be recognized on the balance sheet. We believe it also may be acceptable for an entity to adopt a policy to recognize lease liabilities, but not recognize the related ROU asset on the balance sheet (i.e., a lessee would expense the amount that otherwise would be recognized as the ROU asset at lease commencement).

Although the Board acknowledged in BC 122 that an entity’s practice of adopting a capitalization threshold for leases may be consistent with its accounting policies in other areas of GAAP such as purchases of property, plant and equipment (PP&E), we believe it would be inappropriate for entities to default to using an existing threshold for PP&E because the established threshold does not consider the effect of not recognizing liabilities. Because previously established capitalization thresholds did not contemplate the non-recognition of the additional asset class introduced by ASC 842 (i.e., the ROU asset), entities may need to consider whether their previously established capitalization thresholds in other areas of GAAP remain appropriate. Entities also should consider implications on internal control over financial reporting when establishing or re-evaluating a capitalization threshold.

### Exit or disposal cost obligations under ASC 420 (‘cease-use’ liabilities)

The scope of ASC 420 excludes costs to terminate a contract that is a lease. However, ASC 420 does not specify whether the non-lease component in a contract that contains both a lease and non-lease component continues to be subject to ASC 420.

A lessee that makes the policy election to account for a lease component of a contract and its associated non-lease components as a single lease component allocates all of the contract consideration to the lease component (refer to section 1.4.2.3, *Practical expedient to not separate lease and non-lease components — lessees*), and the lease and associated non-lease components are accounted for as a single lease component under ASC 842. In this case, a lessee does not apply ASC 420 to that contract because leases are excluded from the scope of ASC 420.

A lessee that does not make the policy election to combine the lease and associated non-lease components follows the guidance in ASC 842 to account for the lease component and other applicable guidance to account for the non-lease component. As such, we believe lessees should consider the guidance in ASC 420 for exit or disposal costs associated with the non-lease component.

### R&D activities

A lessee may use an underlying asset in performing research and development (R&D) activities. Under ASC 730, *Research and Development*, materials, equipment and facilities that are acquired or constructed and intangible assets purchased from others for R&D activities are capitalized and depreciated/amortized if they have alternative future use. If an entity cannot identify alternative future use, the costs of those items have no separate economic value and are considered R&D costs that are expensed when incurred. Questions have arisen about whether the guidance in ASC 730 should be applied to ROU assets recognized under ASC 842.

We believe there are two acceptable approaches to the accounting for an operating lease ROU asset related to PP&E used in R&D activities:

* Approach A: A lessee applies the guidance in ASC 730 to the operating lease ROU asset. As a result, an operating lease ROU asset with no alternative future use would be expensed immediately.
* Approach B: A lessee does not apply the guidance in ASC 730 to an operating lease ROU asset. Instead, the lessee applies the subsequent measurement and expense recognition guidance in ASC 842. In accordance with ASC 842, a lessee also determines whether its ROU asset is impaired under ASC 360-10. Refer to section 4.2.5, *Impairment of right-of-use assets in operating leases*, for further discussion.

A lessee should apply its accounting policy election consistently to all operating lease ROU assets and should disclose its accounting policy, if material.

We believe finance lease ROU assets related to PP&E used in R&D activities should be accounted for in a manner similar to purchased PP&E. That is, we believe a lessee should apply the guidance in ASC 730 to finance lease ROU assets.

### Lessee accounting for entities in bankruptcy

Lessees that file for Chapter 11 bankruptcy protection continue to apply ASC 842 when accounting for leases during and upon emergence from bankruptcy. Additional consideration should be given to the guidance in ASC 852 and ASC 805 upon emergence, due to the special requirements of ASC 852 related to emerging from bankruptcy and applying fresh-start accounting.

Refer to sections 2.16, *Leases*; 3.9.9, *Leases*; and 4.4.1, *Leases*, of our FRD, [***Bankruptcies, liquidations***](https://www.ey.com/en_us/technical/accountinglink/financial-reporting-developments-bankruptcies-liquidations-and-quasi-reorganizations)[***and quasi-reorganizations***](https://www.ey.com/en_us/technical/accountinglink/financial-reporting-developments-bankruptcies-liquidations-and-quasi-reorganizations), for further discussion on accounting considerations for lessees before, during and upon emergence from bankruptcy, respectively.

### Lessee accounting for contract manufacturing arrangements

As discussed in section 1.4.2.3, *Practical expedient to not separate lease and non-lease components — lessees*, when a contract manufacturing arrangement contains a lease, the lessee generally is not purchasing inventory. Instead, the lessee is producing inventory with the leased asset (e.g., a manufacturing facility, identified equipment) and the associated manufacturing service provided by the lessor/contract manufacturer. As such, certain costs associated with the lease and non-lease components in a contract manufacturing arrangement may be capitalizable as inventory under ASC 330.

## Presentation

The following table summarizes how lease-related amounts and activities are presented in lessees’

financial statements.

|  |  |
| --- | --- |
| **Financial statement** | **Lessee presentation** |
| Balance sheet | * **Finance leases:**   + ROU assets presented either:     - Separately from other assets (e.g., owned assets) and separately from operating lease ROU assets     - Together with other assets and separate from operating lease ROU assets, with disclosures of the balance sheet line items that include finance lease ROU assets   + Lease liabilities presented either:     - Separately from other liabilities and separately from operating lease liabilities     - Together with other liabilities and separate from operating lease liabilities, with disclosure of the balance sheet line items that include finance lease liabilities and their amounts * **Operating leases:**   + ROU assets presented either:     - Separately from other assets (e.g., owned assets) and separately from finance lease ROU assets     - Together with other assets and separate from finance lease ROU assets, with disclosures of the balance sheet line items that include operating lease ROU assets   + Lease liabilities presented either:     - Separately from other liabilities and separately from finance lease liabilities     - Together with other liabilities and separate from finance lease liabilities, with disclosure of the balance sheet line items that include operating lease liabilities and their amounts |
| Income statement | * **Finance leases:**   + Lease-related amortization and lease-related interest expense are not required to be presented as separate line items and should be presented in a manner consistent with how the entity presents depreciation and amortization of similar assets and other interest expense. However, lease-related amortization and lease-related interest expense cannot be combined in the same line item.   + ASC 842 does not specify income statement presentation of variable lease costs. We believe those costs are generally presented as interest expense but could also be presented as lease expense (i.e., operating expense). See section 4.3.3, *Expense recognition — finance leases* for further discussion. * **Operating leases:**   + Lease expense is included in income from continuing operations. |

|  |  |
| --- | --- |
| **Financial statement** | **Lessee presentation** |
| Statement of cash flows | * **Finance leases:**   + Cash payments for the principal portion of the lease liability are presented within financing activities.   + Cash payments for the interest portion are presented in accordance with ASC 230, *Statement of Cash Flows*. * **Operating leases:**   + Cash payments for lease payments are presented within operating activities, except for payments that represent costs to bring another asset to the condition and location necessary for its intended use, which are presented within investing activities.   + We believe changes in the lease liability and changes in the ROU asset should be separately presented as adjustments to net income within operating activities. For example, a decrease in the ROU asset would be a noncash increase to net income. A lessee should present such amounts gross in the statement of cash flows or provide proper disclosure, if presented net. A lessee should appropriately label such adjustments in the statement of cash flows (e.g., changes in the ROU asset could be described as noncash lease expense, but should not be labeled as amortization expense). * **Both types of leases:**   + Lease payments for short-term leases not recognized on the balance sheet and variable lease payments (not included in the lease liability) are presented within operating activities.   + Noncash activity (e.g., the initial recognition of the lease at commencement) is disclosed as a supplemental noncash item (refer to   section 4.10.1, *Supplemental noncash information*). |

The following example illustrates the cash flow presentation for a lessee.

**Illustration 4-13: Cash flow presentation for a lessee**

Entity L (lessee) enters into a three-year lease of office space that it concludes is an operating lease. The lease commences at the beginning of Year 1. Entity L agrees to make the following annual payments at the end of each year: $10,000 in Year 1, $12,000 in Year 2 and $14,000 in Year 3. For simplicity, there are no purchase options, initial direct costs, payments to the lessor before the lease commencement date, variable payments based on an index or rate, or lease incentives from the lessor. The initial measurement of the right-of-use asset and lease liability is $33,000 using a discount rate of 4.235%. Entity L uses its incremental borrowing rate because the rate implicit in the lease cannot be readily determined. Entity L calculates that the annual straight-line lease expense is

$12,000 per year [($10,000 + $12,000 + $14,000) ÷ 3].

A summary of Entity L’s accounting for the operating lease (assuming no changes due to reassessment, lease modification or impairment) is as follows:

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | **Initial** |  | **Year 1** |  | **Year 2** | **Year 3** |
| Cash lease payments: |  |  | $ 10,000 | (9) | $ 12,000 | $ 14,000 |
| *Income statement:* |  |  |  |  |  |  |
| Periodic lease expense (straight-line) |  |  | (12,000) | (1) | (12,000) | (12,000) |
| (Accrued) prepaid rent for period |  |  | $ (2,000) |  | $ — | $ 2,000 |
| *Balance sheet:* |  |  |  |  |  |  |
| Lease liability | $ (33,000) | (6) | $ (24,398) | (7) | $ (13,431) | $ — |
| Right-of-use asset |  |  |  |  |  |  |
| Lease liability | $ 33,000 | (13) | $ 24,398 |  | $ 13,431 | $ — |
| (Accrued) prepaid rent  (cumulative) | — |  | (2,000) |  | (2,000) | — |
|  | $ 33,000 | (3) | $ 22,398 | (4) | $ 11,431 | $ — |

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | **Initial** |  | **Year 1** |  | **Year 2** | **Year 3** |
| Cash lease payments  Cash payments of principal Cash payments of interest |  |  | $ 10,000  8,602  1,398 | (10)  (8)  (11) | $ 12,000  10,967  1,033 | $ 14,000  13,431  569 |
| *Income statement* |  |  |  |  |  |  |
| Interest expense |  |  | $ (1,398) |  | $ (1,033) | $ (569) |
| Amortization expense |  |  | (11,000) | (5) | (11,000) | (11,000) |
| Total periodic expense |  |  | $ (12,398) | (2) | $ (12,033) | $(11,569) |
| *Balance sheet* |  |  |  |  |  |  |
| Lease liability | $ (33,000) |  | $ (24,398) |  | $ (13,431) | $ — |
| Right-of-use asset | $ 33,000 | (12) | $ 22,000 |  | $ 11,000 | $ — |

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Operating lease** | | | **Finance lease** | |
|  | **ROU asset** | **Lease liability** | **ROU asset** | **Lease liability** |
| Beginning balance Year 1 New lease | $ —  33,000 | $ —  (33,000) | $ —  33,000 | $ —  (33,000) |
| Change in operating lease liability\* | (8,602) | 8,602 |  |  |
| Accrued rent | (2,000) |  |  |  |
| ROU asset amortization |  |  | (11,000) |  |
| Interest accretion |  |  |  | (1,398) |
| Cash lease payments |  |  |  | 10,000 |
| Ending balance Year 1 | $ 22,398 | $ (24,398) | $ 22,000 | $ (24,398) |

|  |
| --- |
| Immaterial differences may arise in the recomputation of amounts in the example above due to rounding.  At the same time it enters into the operating lease, Entity L (lessee) enters into a three-year lease of equipment that it concludes is a finance lease because the lease term is for a major part of the remaining economic life of the underlying asset (also three years). Otherwise, the terms of this lease are the same as those of the operating lease.  That is, the finance lease commences at the beginning of Year 1. Entity L agrees to make the following annual payments at the end of each year: $10,000 in Year 1, $12,000 in Year 2 and $14,000 in Year 3. For simplicity, there are no purchase options, initial direct costs, payments to the lessor before the lease commencement date, variable payments based on an index or rate, or lease incentives from the lessor. The initial measurement of the right-of-use asset and lease liability is $33,000 (present value of lease payments using a discount rate of 4.235%). Entity L uses its incremental borrowing rate because the rate implicit in the lease cannot be readily determined.  Entity L amortizes the right-of-use asset on a straight-line basis over the lease term.  A summary of Entity L’s accounting for the finance lease (assuming no changes due to reassessment, lease  modification or impairment) is as follows:  Immaterial differences may arise in the recomputation of amounts in the example above due to rounding.  Entity L prepares the following rollforward of the ROU assets and lease liabilities for Year 1 in order to make sure cash and non-cash activities are properly identified and presented in the statement of cash flows:  \* This amount is to adjust the lease liability to the present value of the remaining lease payments with an offset to the right-of- use asset ($10,000 – ($33,000 x 4.235%)). |

|  |
| --- |
| For simplicity, assume that Entity L does not have any other activity other than the operating and finance lease. Cash flow presentation for Year 1 is as follows: |

### Presentation of ROU assets and lease liabilities in classified balance sheets

|  |  |  |
| --- | --- | --- |
| Year 1 |  |  |
| **Operating activities** |  |  |
| Net income | $ (24,398) | (1) + (2) |
| Adjustments to reconcile net income to net cash used in operating activities: | | |
| Noncash operating lease expense | 10,602 | (3) - (4) |
| ROU asset amortization for finance lease | 11,000 | (5) |
| Changes in operating assets and liabilities |  |  |
| Change in operating lease liability | (8,602) | (6) - (7) |
| **Net cash used in operating activities** | (11,398) |  |
| **Investing activities** |  |  |
| Investing activities | — |  |
| **Net cash provided by (used in) investing activities** | — |  |
| **Financing activities** |  |  |
| Payments on principal portion of finance lease obligation | (8,602) | (8) |
| **Net cash used in financing activities** | (8,602) |  |
| **Net decrease in cash, cash equivalents and restricted cash** | (20,000) | (9) + (10) |
| **Cash, cash equivalents and restricted cash at beginning of year** | - |  |
| **Cash, cash equivalents and restricted cash at end of year** | $ (20,000) |  |
| **Supplemental disclosures:** |  |  |
| Cash paid for interest (230-10-50-2) | (1,398) | (11) |
| Noncash recognition of new leases (ASC 842-20-50-4(g)(2)) | 66,000 | (12) + (13) |

Consistent with the classification of property, plant and equipment, and other assets that are depreciated or amortized, we believe right-of-use assets generally should be classified as a single noncurrent asset.

We believe a lessee should classify current and noncurrent portions of its lease liabilities consistent with the guidance in ASC 210, *Balance Sheet*. Under that guidance, current liabilities include liabilities whose liquidation is expected to occur within 12 months (or operating cycle, if longer). For example, we believe one acceptable approach is for a lessee to determine the current and noncurrent portions of its lease liabilities as follows:

* Calculate the current liability as the present value of lease payments to be made within 12 months (or operating cycle, if longer) from the balance sheet date.
* Calculate the noncurrent liability as the portion of the lease liability to be paid following 12 months (or operating cycle, if longer) from the balance sheet date (i.e., the difference between the total lease liability and the current portion).

|  |
| --- |
| **Illustration 4-14: Calculation of current and noncurrent lease liabilities in classified balance sheets** |
| Manufacturer enters into a lease of equipment for its production line from Lessor. The lease commences on 1 January 20X1, has a lease term of 4 years and annual payments of $100 due in arrears. Manufacturer determines the current portion of its lease liability based on payments to be made within the next 12 months.  After the initial payment on 31 December 20X1, Manufacturer calculates its remaining lease liability at 31 December 20X1, 20X2 and 20X3, using its IBR at lease commencement of 6%:  **20X1 20X2 20X3**  Total lease liability $ 267 $ 183 $ 94  *Analysis:* Manufacturer determines the current and noncurrent portions of its lease liability for the year ended 31 December 20X1 as follows:   * The current liability is calculated as the present value of lease payments to be made within   12 months (present value of $100 due at the end of year 2, discounted at the IBR of 6% = $94).   * The noncurrent liability is the difference between the total lease liability and the current portion ($267 less $94 current portion = $173). |

### Other presentation matters

In certain situations, the carrying amount of an ROU asset may be reduced below zero (i.e., the ROU asset has a negative carrying amount). For example, this may occur if the only lease payments are variable lease payments that do not depend on an index or rate and the lessee receives a lease incentive (e.g., an up-front cash payment from the lessor) upon executing a lease. That’s because the incentive is deducted from the carrying amount of the ROU asset, which would otherwise be zero when there are only variable lease payments that do not depend on an index or rate. ASC 842 does not address the presentation of an ROU asset that is reduced below zero. We believe these ROU assets should be reclassified and presented as liabilities, separate from any related lease liability. However, this presentation guidance does not apply when a lease liability is remeasured upon certain lease modifications or other lease liability remeasurement events and the corresponding ROU asset is reduced to zero. In those cases, any remaining amount of the remeasurement is recognized in profit or loss (refer to section 4.5, *Remeasurement of lease liabilities and right-of-use assets – operating and finance leases*).

## Disclosure (updated August 2023)

The objective of lessee disclosures is to enable financial statement users to assess the amount, timing and uncertainty of cash flows arising from leases. ASC 842 requires a lessee to disclose quantitative and qualitative information about its leases, the significant judgments and assumptions made in applying

ASC 842 and the amounts recognized in the financial statements related to those leases. ASC 842 does not

require a specific format for lessees’ quantitative disclosures but includes an example in a tabular format.

Lessees may need to exercise judgment to determine the appropriate level at which to aggregate or disaggregate disclosures so that meaningful information is not obscured by insignificant details or by groupings of items with different characteristics. The disclosure requirements apply to all entities.

There are no required interim period lessee disclosures. However, a lessee should evaluate whether it needs to make additional interim disclosures under ASC 270, *Interim Reporting*, and Article 10 of Regulation S-X for SEC registrants (also refer to ASC 270-10-S99-1). For example, a lessee may include interim lease disclosures that are consistent with its annual financial statements if its leasing activities are significant or if there are significant events or changes in its leasing activities during the interim period.

When the useful life of leasehold improvements to the common control group exceeds the lease term, a lessee is required to disclose the unamortized balance of the leasehold improvements at the balance sheet date, their remaining useful life to the common control group and the remaining lease term. We believe that the disclosures on remaining useful life and lease term can be provided on a weighted-average basis (as applicable) by class of underlying asset. Refer to section 4.7.3.4, *Lessee amortization of leasehold improvements associated with a lease between entities under common control* for further details.

### Supplemental noncash information

ASC 842-20-50-4(g) requires a lessee to disclose supplemental noncash information for lease liabilities arising from new right-of-use assets. Consistent with the ASC 230’s guidance that requires disclosure of all noncash investing and financing activities, in addition to the noncash disclosures for the initial recognition of a new lease, a lessee should also make disclosures for other noncash changes to lease balances, including modifications (refer to section 4.6, *Lease modifications*) and remeasurement of the lease liabilities and right-of-use assets, including those resulting from a reassessment of the lease term and purchase options (refer to sections 4.5, *Remeasurement of lease liabilities and right-of-use assets — operating and finance leases*, and 2.3.6, *Reassessment of the lease term and purchase options*).

For example, a lessee would disclose noncash changes related to an increase in the right-of-use asset resulting from a reassessment event where there is an increase in the lease term (refer to section 2.3.6.1, *Reassessment of the lease term and purchase options — lessees*, for more discussion on lessee reassessment events).

## Lessee illustrations

# Subleases

## Definition of a sublease

|  |
| --- |
| **Excerpt from Accounting Standards Codification** |
| Master Glossary  *Sublease*  A transaction in which an **underlying asset** is re-leased by the **lessee** (or intermediate **lessor**) to a third party (the sublessee) and the original (or head) **lease** between the lessor and the lessee remains in effect. |

Lessees often enter into arrangements to sublease an underlying asset to a third party. In these arrangements, one party acts as both the lessee and lessor of the same underlying asset. The original lease is often referred to as a head lease, the original lessee is often referred to as an intermediate lessor or sublessor, and the ultimate lessee is often referred to as the sublessee.

Sublease



Lessor

Head lease

* The accounting for the original lease doesn’t change.
* Sublease term may affect head lease classification.
* Consider the underlying asset for classification purposes (rather than the ROU asset arising from the head lease).
* Use the discount rate of the head lease if the rate implicit in the lease cannot be readily determined.
* Additional sublease disclosures are required.

Lessee/sublessee

Original lessee/sublessor

* Lease classification is assessed in the same manner as any new lease.
  + Consider the underlying asset for classification purposes (rather than the ROU asset arising from the head lease).

In some cases, the sublease is a separate lease agreement. In other cases, a third party assumes the original lease, but the original lessee remains the primary obligor under the original lease.

### The original lessee is relieved of the primary obligation — not a sublease

If the original lessee is relieved of the primary obligation under the original lease, the transaction is not a sublease. Such transactions are considered a termination (refer to section 4.8.1, *Lease termination*) of the original lease, and the lease-related assets and obligations are derecognized. Any consideration paid or received upon termination that was not already included in the lease payments (e.g., a termination penalty that was not included in lease payments based on the lease term) is included in the gain or loss on termination of the original lease. If the original lessee remains secondarily liable for the original lease, the guarantee obligation is recognized by the lessee in accordance with ASC 405-20-40-2 (i.e., measured at fair value and included in the determination of gain or loss on lease termination).

## Original lessor accounting for a sublease

If the original lessee enters into a sublease or sells or transfers the original lease to a third party, the original lessor does not change its accounting for the original lease. However, if the original lease agreement is replaced by a new agreement with a new lessee, the original lessor accounts for both the termination of the original lease and the new lease as separate transactions. Refer to section 5.7.3, *Lease termination*.

## Sublessor accounting

If an underlying asset is re-leased by a lessee to a third party and the original lessee retains the primary obligation under the original lease, the transaction is a sublease. A sublessor assesses sublease classification independently of the classification assessment that it made as the lessee of the same asset. A sublessor considers the lease classification criteria in section 3.2, *Criteria for lease classification — lessors*, with reference to the underlying asset when classifying a sublease (e.g., the underlying asset subject to the sublease) rather than the right-of-use asset recognized as part of the head lease. A sublessor uses the rate implicit in the lease (i.e., the rate implicit in the sublease) to determine the classification of the sublease and to measure the net investment in a sublease that is classified as a sales- type or a direct financing lease. If the rate implicit in the lease cannot be readily determined, the sublessor uses the discount rate for the lease established for the head lease. Refer to section 3.4.10, *Classification of subleases,* and section 2.5, *Discount rates*.

The following table summarizes how the original lessee/sublessor accounts for the head lease and sublease at the commencement of the sublease.

|  |  |  |
| --- | --- | --- |
|  | **Sublease — sales-type or direct financing lease** | **Sublease — operating lease** |
| **Head lease — finance lease** | The original lessee derecognizes the original right-of- use asset and continues to account for the original lease liability as it did before the commencement of the sublease (i.e., in accordance with the finance lease provisions of the lessee accounting guidance). The original lessee, as the sublessor, recognizes a net investment in the sublease and evaluates it  for credit impairment under ASC 326. Refer to section 2.11.3, *Leases*, of our FRD, [***Credit impairment***](https://www.ey.com/en_us/technical/accountinglink/financial-reporting-developments---credit-impairment-under-asc-326)[***under ASC 326***,](https://www.ey.com/en_us/technical/accountinglink/financial-reporting-developments---credit-impairment-under-asc-326) for additional details. Additionally, refer to section 5.2.3, *Credit losses on the net investment in the lease — sales-type leases.* | The original lessee continues to account for the head lease as it did before the commencement date of the sublease (i.e., in accordance with the lessee accounting guidance).  If the lease cost for the term of the sublease exceeds the sublessor’s anticipated sublease income for the same period, this indicates that the right-of-use asset associated with the head lease should be assessed for impairment under the long-lived asset impairment provisions of ASC 360-10 (i.e., an impairment indicator). |
| **Head lease —**  **operating lease** | The original lessee derecognizes the original right-of- use asset at the sublease commencement date and accounts for the original lease liability in accordance with the finance lease provisions of the lessee accounting guidance. The original lessee, as the sublessor, recognizes a net investment in the sublease and evaluates it for credit impairment under ASC 326. Refer to section 2.11.3, *Leases*, of our FRD, [***Credit impairment under ASC 326***](https://www.ey.com/en_us/technical/accountinglink/financial-reporting-developments---credit-impairment-under-asc-326), for additional details. Additionally, refer to section 5.2.3, *Credit loss on the net investment in the lease — sales- type leases.* |

Sublease may affect head lease classification

When a sublessor enters into sublease arrangements and determines that the term of the sublease (including the noncancelable term and any lease renewal options that are reasonably certain to be exercised by the sublessee or controlled by the sublessor) is longer than the lease term of the head lease, the sublessor is required to reassess the lease term of the head lease in accordance with ASC 842-10-35-1(a) as discussed in section 2.3.6.1, *Reassessment of the lease term and purchase options — lessees*. However, the existence of the renewal option on its own does not result in the head lease being extended.

For example, assume a head lease has a noncancelable term of five years and provides a lessee with an option to renew for two additional years that it determines it is not reasonably certain to exercise. If the lessee subleases the underlying asset and provides the sublessee with the same noncancelable term and renewal option and determines that the sublessee is reasonably certain to exercise that renewal option, the lessee would reassess the term of the head lease as the renewal options are now reasonably certain to be exercised. This is because the lease term under the sublease effectively establishes an obligation to renew the head lease. If the lease term of the head lease changes, the sublessor is also required to reassess the lease classification of the head lease. Refer to section 3.5, *Reassessment of lease classification*. Alternatively, if the lessee determines that the sublessee is not reasonably certain to exercise the renewal option, the lessee would not remeasure the lease term on the head lease solely as a result of entering into the sublease (refer to section 3.5.1, *Summary of lease reassessment and remeasurement requirements*, for a discussion of events that could result in reassessment).

Likewise, a head lease may provide a lessee with an option to purchase the underlying asset that it determines it is not reasonably certain to exercise. If the lessee then subleases the underlying asset and provides the sublessee with a purchase option and determines that the sublessee is reasonably certain to exercise that option, the sublessor will change its assessment of whether it is reasonably certain to exercise its purchase option on the head lease to fulfill the terms of the sublease in accordance with ASC 842-10-35-1(c) as discussed in section 2.3.6.1, *Reassessment of the lease term and purchase options — lessees*. The sublessor is also required to reassess the lease classification of the head lease as discussed in section 3.5, *Reassessment of lease classification*.

Recognition of profit or loss

ASC 842 does not address when the sublessor should recognize the selling profit (sales-type lease) or loss (sales-type or direct financing lease) resulting from a sublease. We believe that any selling profit should be recognized at the sublease commencement date (i.e., the date on which a sublessor makes the underlying asset available for use by a sublessee) when a sublease is classified as a sales-type lease or deferred when a sublease is classified as a direct financing lease. When a sublease is classified as a sales- type or direct financing lease, we believe that any selling loss should be recognized no later than the sublease commencement date (i.e., selling loss is not deferred), consistent with the accounting for a sales-type or direct financing lease, and in some cases earlier as an impairment of the right-of-use asset under the head lease.

We also believe that when a sales-type sublease is for a portion of the underlying asset, the sublessor must determine the portion of the right-of-use asset to derecognize on a rational and systematic basis (e.g., by relative fair value). Likewise, a sublessor must determine the portion of the lease liability that may be converted from an operating lease to a finance lease for purposes of subsequent measurement on a rational and systematic basis (e.g., in proportion to the right-of-use asset).

Presentation of sublease income

ASC 842 does not address how a sublessor should present the income from a sublease in the statement of comprehensive income. However, the FASB indicated in the Basis for Conclusions (BC 115) of

ASU 2016-02 that the head lease and the sublease should be accounted for as two separate contracts unless those contracts meet all of the criteria in ASC 842’s contract combinations guidance. Therefore, we believe that the sublessor should present the income from a sublease separately from the lease expense on the head lease (i.e., gross presentation) unless both the head lease and the sublease meet all of the criteria in the contract combinations guidance in ASC 842-10-25-19. Refer to section 1.5, *Contract* combinations, for further information about contract combinations. However, we are aware that diversity exists in this area and that other forms of presentation may be acceptable in certain situations.

Regardless of the presentation in the statement of comprehensive income, ASC 842 requires an original lessee/sublessor to disclose sublease income, on a gross basis, separate from finance or operating lease expense. Refer to section 6.5, *Disclosure*, for other disclosure requirements.

In some instances, a sublessee may be required to make variable lease payments directly to the head lessor, rather than to the sublessor. ASC 842 requires a lessor to exclude lessor costs paid directly by a lessee to third parties on the lessor’s behalf (e.g., taxes) from variable payments. However, a sublessor should not exclude a sublessee’s variable lease payments that are not lessor costs (e.g., variable payments based on sales) from variable payments. Rather, a sublessor should present the sublessee’s variable lease payments made directly to the head lessor as variable sublease income separately from lease expense on the head lease (i.e., gross presentation). If the sublessor does not know the amount of these payments, it should develop reasonable estimates of the amount.

Right-of-use asset groups for purposes of impairment assessments

Lessees’ right-of-use assets, for both operating and finance leases, are subject to existing impairment guidance in ASC 360-10 (refer to section 4.2.5, *Impairment of right-of-use assets in operating leases*, and section 4.3.4*, Impairment of right-of-use assets in finance leases*). Questions have arisen regarding whether the original asset group that included the ROU asset should be reassessed for purposes of the ASC 360-10 impairment assessment if all or part of the original ROU asset is subleased to a third party.

We believe in certain circumstances it is reasonable for the original lessee to conclude that a subleased portion of a right-of-use asset meets the criteria to be identified as a single lease component. For example, an original lessee may conclude there is no accounting difference between accounting for its lease of a 10-floor building as one lease component (the building) or as 10 lease components (the 10 functionally independent floors). That is, even though each floor meets the criteria to be considered a separate lease component (refer to section 1.4.1, *Identifying and separating lease components of a contract*), the original lessee may have historically accounted for the entire 10-floor building as one lease component because there is no accounting difference between recognizing 10 separate right-of-use assets and lease liabilities and recognizing one right-of-use asset and lease liability for the entire building. Therefore, in this example, if the original lessee subleases a single functionally independent floor, we believe it is also reasonable to disaggregate the right-of-use asset for the subleased floor from the existing asset group as long as that floor meets the criteria to be identified as a separate lease component (refer to section 1.4.1, *Identifying and separating lease components of a contract*).

As mentioned above, in accordance with ASC 842-20-35-14, if 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.

Therefore, in the example above, the original lessee would disaggregate the asset group in order to derecognize the portion of the asset being subleased.

## Sublessee accounting

A sublessee accounts for a sublease in the same manner as any other lease (i.e., as a new lease subject to ASC 842’s recognition and measurement provisions). Refer to section 4, *Lessee accounting*. A sublessee classifies the sublease by referring to the underlying asset rather than by referring to the right- of-use asset arising from the head lease.

## Disclosure

In addition to making other lessor disclosures (refer to section 5.9, *Disclosure*), ASC 842 requires an original lessee/sublessor to disclose (1) the existence, and terms and conditions, of residual value guarantees provided by the sublessee and (2) sublease income, on a gross basis, separate from finance or operating lease expense.