

A close-up photograph of architectural blueprints and a pencil. The blueprints show floor plans with various rooms, dimensions, and labels like 'Cavalar' and 'FIRE ALARM'. A green pencil lies across the bottom right corner of one of the blueprints.

# BLUEPRINT: A BDO SERIES

# Accounting for Leases Under ASC 842

Updated April 2023

**BDO**<sup>®</sup>

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## THIS BLUEPRINT

The Blueprint includes detailed guidance and flowcharts on analyzing and accounting for contracts under Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 842, *Leases*. The graphics and illustrations in this Blueprint are provided to assist readers in understanding various aspects of the lease accounting guidance. Accounting for contracts may vary based on the specific facts and circumstances of each contract and therefore may differ from the illustrations provided in the Blueprint.

The Blueprint focuses on the accounting for lease contracts under ASC 842 only. Additional information on the accounting for leases under International Financial Reporting Standards (IFRS) is available [here](#).



# INTRODUCTION



In February 2016, the Financial Accounting Standards Board (“FASB”) issued new lease accounting guidance in ASU 2016-02, Leases (“ASC 842”). Under its core principle, a lessee recognizes a right-of-use (“ROU”) asset and a related lease liability on the balance sheet for most leases. The most significant change is on the balance sheet for lessees. For the income statement, the pattern of expense recognition depends on a lease’s classification but is generally consistent with current U.S. GAAP (ASC 840, Leases, or “ASC 840”).

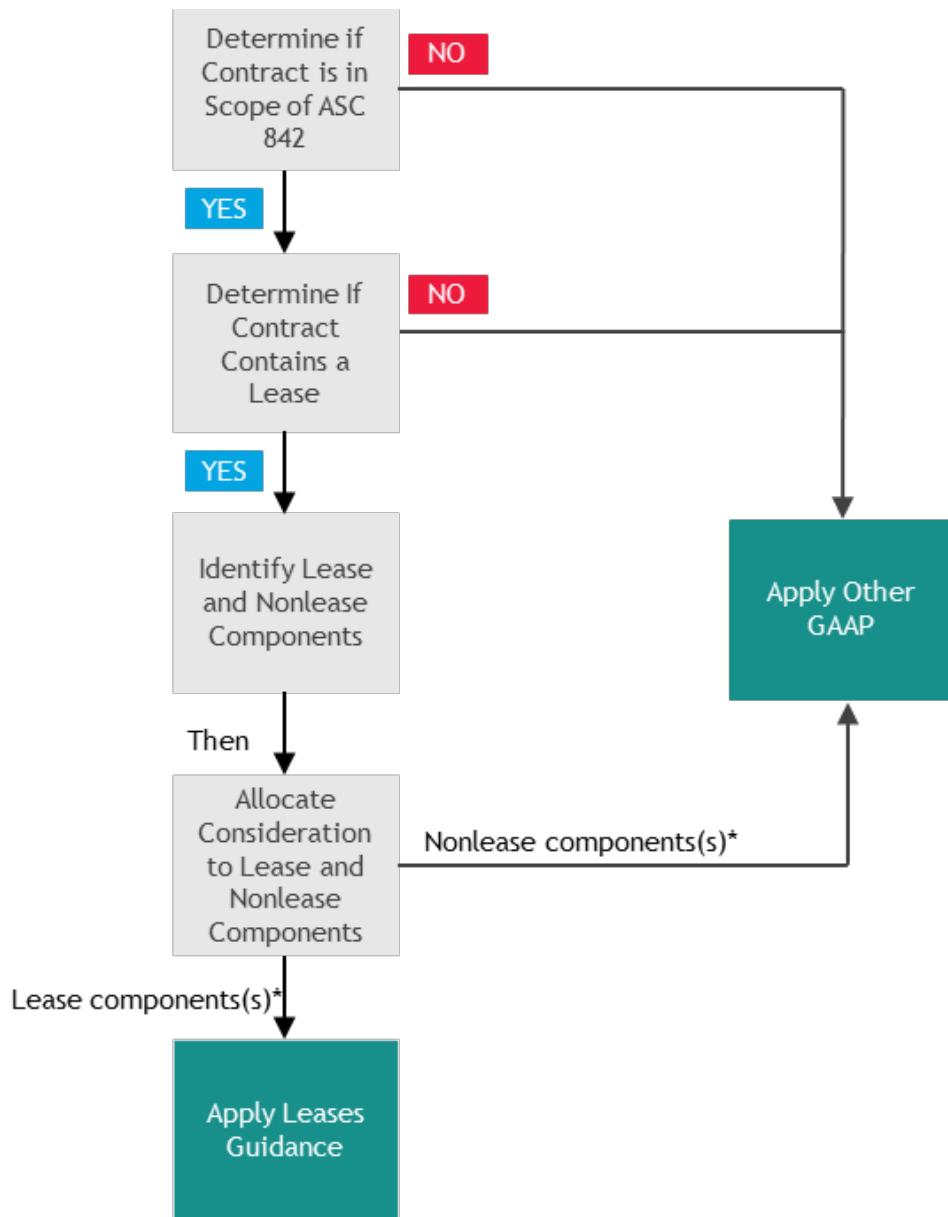
The objective for updating lease accounting was to increase transparency and comparability among entities by recognizing lease assets and lease liabilities on the balance sheet by lessees for most leases and by disclosing key information about leasing arrangements. This new guidance addressed stakeholder concerns that the previous lease accounting guidance did not result in a faithful representation of leasing transactions; specifically, that the rights and obligations associated with operating leases were not recognized on the balance sheet.

Under ASC 840, lessees recognized capital leases on the balance sheet but only disclosed operating leases as off-balance sheet arrangements. There were no major differences in the accounting treatment for an operating lease versus a service contract. ASC 842 now changes that and, as such, the key determination will be whether a contract is or contains a lease as that will drive whether a contract is recognized on the balance sheet.

The leases project began as one of several joint projects between the FASB and the International Accounting Standards Board (IASB) aimed at converging U.S. GAAP and International Financial Reporting Standards (IFRS). However, after several years of deliberations and two exposure drafts, the FASB and IASB reached different conclusions on various aspects of lease accounting (such as classification of leases by lessees), and each of FASB and IASB issued separate guidance early in 2016. Additional information on the accounting for leases under IFRS is available [here](#).

## ASC 842 IN A NUTSHELL

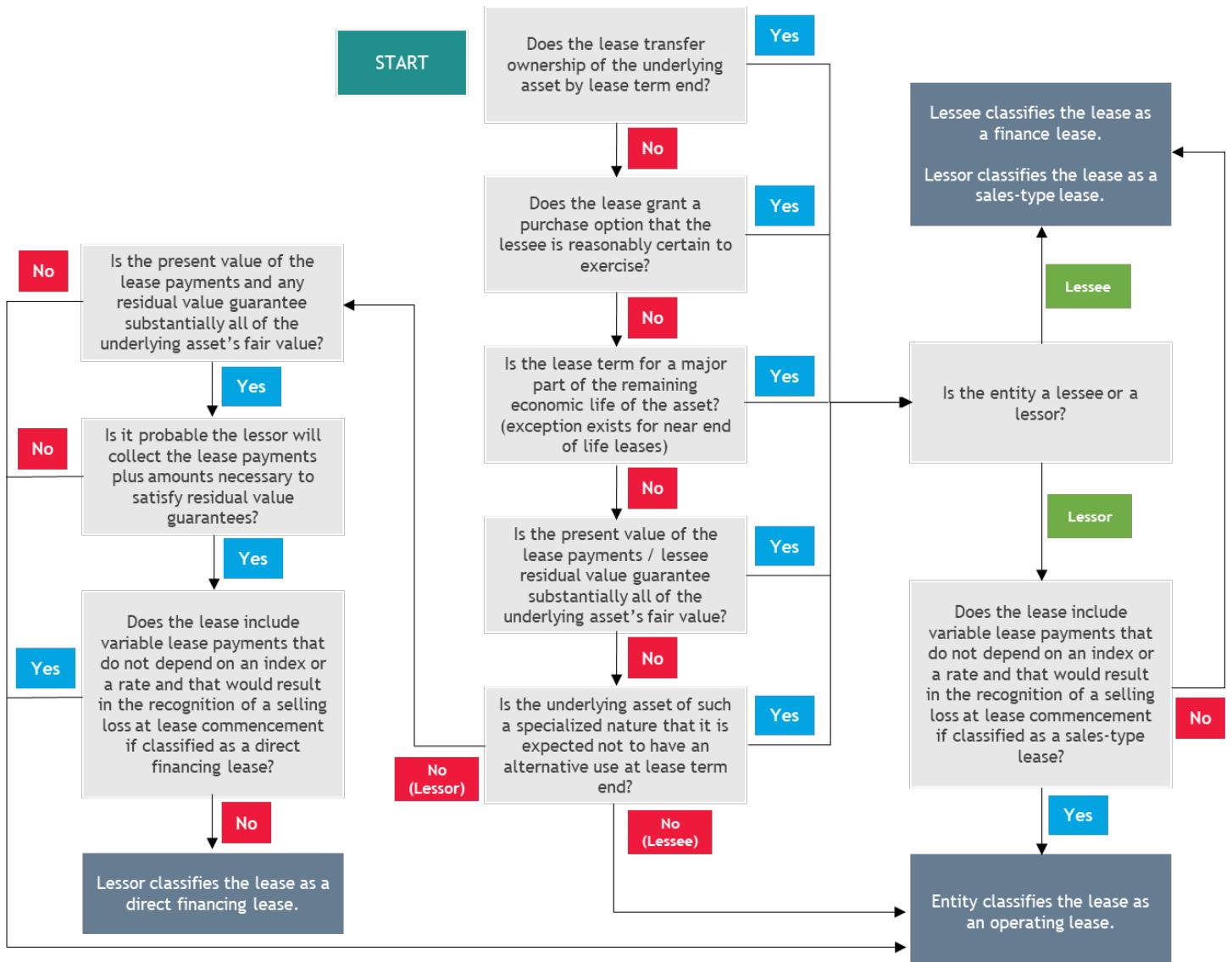
The following flowchart summarizes at a high level what an entity considers when applying ASC 842, which we will explore in further details throughout the Blueprint.



\* Exceptions exist when a lessee or lessor elect a practical expedient not to separate nonlease component(s) from the associated lease component (see Chapter 3).

## LEASE CLASSIFICATION

The following flowchart summarizes classification of a lease by lessees and lessors under ASC 842 (after adoption of ASU 2021-05):



## LESSEE ACCOUNTING

As illustrated on the previous page, a lessee classifies a lease as either an operating lease or a finance lease using classification criteria that are generally consistent with ASC 840. The lease (whether operating or finance) is recognized on balance sheet at the commencement date unless the practical expedient for short-term leases is elected (see below). The following table summarizes a lessee's accounting for leases:

|                     | FINANCE LEASES   |   | OPERATING LEASES   |   |
|---------------------|--|---|--|---|
|                     | ROU ASSET  | LEASE LIABILITY   | ROU ASSET  | LEASE LIABILITY   |
| Balance Sheet       | ROU asset is initially measured at the amount of the lease liability, plus initial direct costs and prepaid lease payments, less lease incentives received.                                      | Lease liability is initially measured at the present value of the unpaid lease payments.  | Initial measurement is the same as for finance leases.   |   |
|                     | Subsequently, ROU asset is typically amortized on a straight-line basis to the earlier of the end of its useful life or lease term. <sup>1</sup>   | Subsequently, lease liability is increased to reflect interest using the effective interest method and decreased for lease payments made. | Amortize based on difference between periodic straight-line lease cost (incl. amortization of initial direct costs) and periodic interest accretion.   | Subsequent measurement is the same as for finance leases. |
| Income Statement    | Recognize amortization on ROU asset, interest on lease liability, and recognize variable lease payments not included in the lease liability when incurred. <sup>2</sup>                          |   | Recognize single lease cost (i.e., lease payments plus initial direct costs) generally on a straight-line basis, and variable lease payments not included in lease liability when incurred. <sup>2</sup> |   |
| Cash Flow Statement | Classify repayments of principal portion of lease liability within financing activities and payments of interest on the lease liability and variable lease payments within operating activities. |   | Classify all cash payments for leases within operating activities.   |   |

Once recognized on balance sheet, ASC 842 includes requirements for lessees to update the measurement of leases for certain lease modifications and other reassessment events. Lessees will need robust processes and controls to timely and completely identify and account for such events. When the lease liability is remeasured and the ROU asset adjusted, amortization of the ROU asset is adjusted prospectively from the date of remeasurement.

The FASB also provided lessees with a practical expedient not to recognize short term leases on balance sheet. A short-term lease is a lease with a lease term of 12 months or less and that does not include a lessee option to purchase the underlying asset that is reasonably certain of exercise. This election is by asset class and, if elected, a lessee recognizes lease payments on a straight-line basis over the lease term along with variable lease payments when incurred, consistent with ASC 840.

<sup>1</sup> If the lease transfers ownership of the underlying asset to the lessee or the lessee is reasonably certain to exercise an option to purchase the underlying asset, the lessee amortizes the right-of-use asset to the end of the useful life of the underlying asset.

<sup>2</sup> If the ROU asset is impaired under ASC 360, an impairment loss is also recognized. For operating leases only, recognition in the income statement post-impairment no longer is on a straight-line basis (but still recognized as a single lease cost).

## LESSOR ACCOUNTING

Lessor accounting remains largely consistent with ASC 840, and a lessor will continue to classify leases as either sales-type, direct financing or operating leases. But lessor accounting has also been updated for consistency with the new lessee accounting model and with the new revenue standard in ASC 606, Revenue from Contracts with Customers (“ASC 606”).

The following table summarizes a lessor’s accounting for leases under ASC 842.

|                     | SALES-TYPE LEASES  | DIRECT FINANCING LEASES   | OPERATING LEASES  |
|---------------------|--|---|---|
| Balance Sheet       | Derecognize underlying asset and recognize net investment in the lease at commencement date if collectability of lease payments and lessee residual value guarantee is probable. <sup>3</sup>  | Derecognize underlying asset and recognize net investment in the lease (which includes selling profit and initial direct costs) at commencement date.   | Continue to recognize underlying asset.<br>Defer initial direct costs.  |
| Income Statement    | Recognize selling profit or loss. Expense initial direct costs (unless fair value of the underlying asset equals its carrying amount, in which case initial direct costs are included in the net investment in the lease).   | Recognize selling loss, if any.   | Recognize lease payments generally on a straight-line basis over the lease term if collectability is probable. Otherwise, lease income is limited generally to lease payments collected.<br>Recognize variable lease payments in period when changes in facts and circumstances on which payments are based occur.<br>Expense initial direct costs on same basis as lease income over the lease term.<br>Recognize depreciation expense (and impairment of underlying asset, if any). |
| Cash Flow Statement | Recognize interest income on net investment in the lease.<br>Recognize variable lease payments not included in net investment in the lease in period when changes in facts and circumstances on which payments are based occur.<br>Recognize impairment (or credit losses) on net investment in the lease. | Classify all payments received as operating cash flows, except for entities within the scope of ASC 942, Financial Services—Depository and Lending, which present principal payments within investing activities. | Classify all payments received as operating cash flows.   |

Also, leveraged lease accounting no longer exists for leases that are entered into or modified after ASC 842’s effective date. As a result, new or modified leases that previously met the definition of a leveraged lease will be accounted for as one of the three types of leases described in the above table. But existing leveraged leases are grandfathered even once ASC 842 is adopted and will continue to be accounted for by a lessor similarly to under ASC 840 until they expire or are modified.

<sup>3</sup> If collectability is not probable at commencement date, a lessor does not derecognize the underlying asset and instead recognizes lease payments received, including variable lease payments, as a deposit liability until further conditions are met.

## ADOPTION DATES

For calendar-year public business entities, certain not-for-profit organizations and certain employee benefit plans, the new standard took effect in 2019, and interim periods within that year.

For all other calendar-year entities, ASC 842 was initially required to take effect in 2020, and interim periods in 2021. However, in November 2019 the FASB issued ASU 2019-10 which initially deferred the effective date of ASC 842 for all other calendar-year entities to 2021 with interim periods in 2022. Also, because of the disruption caused by the Coronavirus Disease 2019 (also referred to as COVID-19), including resource constraints, dislocation, and other priorities that entities faced with the COVID-19 pandemic, the FASB decided to further defer the effective date of ASC 842 by an additional year for private companies and certain not-for-profit entities (NFPs). Specifically, for private companies and private NFPs, ASC 842 will be effective for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. For public NFPs that have not yet issued financial statements or made financial statements available for issuance as of June 3, 2020, ASC 842 takes effect for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years.

Early adoption continues to be permitted for all entities.

## ABOUT THE BLUEPRINT

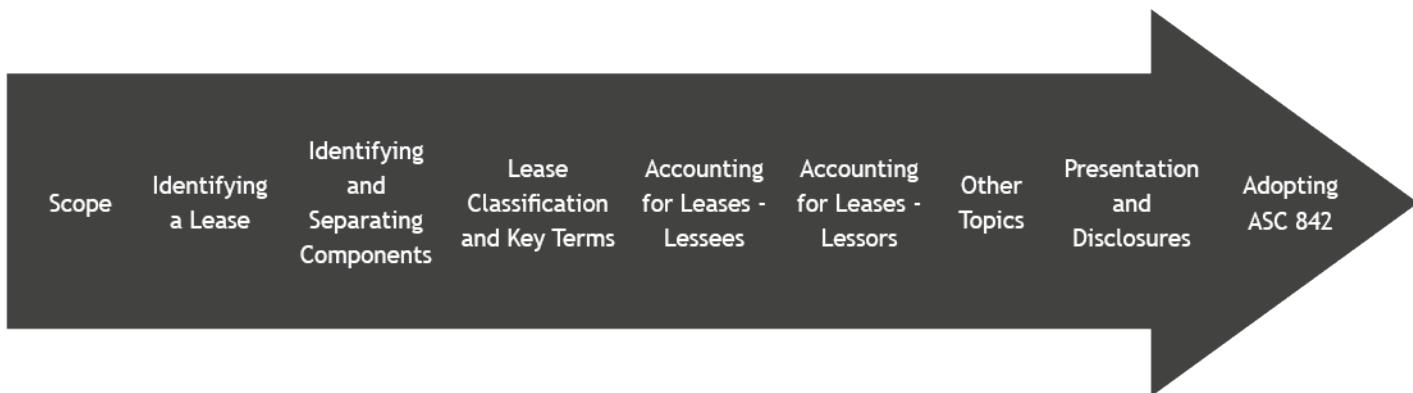
The Blueprint reflects key aspects of the following accounting standards updates (all of which are referred to as ASC 842 in this publication):

- ▶ ASU 2016-02, Leases (Topic 842)
- ▶ ASU 2018-01, Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842, which generally simplifies adoption for entities with land easements that exist or expire before the entity's adoption of ASC 842.
- ▶ ASU 2018-10, Codification Improvements to Topic 842, Leases, which affects narrow aspects of the guidance in ASC 842 and corrects cross-reference inconsistencies.
- ▶ ASU 2018-11, Leases (Topic 842): Targeted Improvements, which the FASB issued to reduce costs for entities in adopting ASC 842 and to ease the application of the separation and allocation guidance for lessors.
- ▶ ASU 2018-20, Leases (Topic 842): Narrow-Scope Improvements for Lessors, which simplifies lessor's accounting for sales taxes, certain lessor costs, and clarifies the recognition of certain variable payments for contracts with lease and nonlease components.
- ▶ ASU 2019-01, Leases (Topic 842): Codification Improvements, which clarifies the application of certain aspects of ASC 842 primarily for financial institutions.
- ▶ ASU 2019-10, Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates, which deferred the effective of ASC 842 for certain entities.
- ▶ ASU 2020-02, Financial Instruments—Credit Losses (Topic 326) and Leases (Topic 842): Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 119 and Update to SEC Section on Effective Date Related to Accounting Standards Update No. 2016-02, Leases (Topic 842), which clarifies the SEC's views on ASC 842's effective date for certain public business entities.
- ▶ ASU 2020-04, Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting, which was issued to simplify an entity's accounting associated with modifications to agreements related to the reference rate reform, including lease contracts.
- ▶ ASU 2020-05, Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities, which further defers the effective date of ASC 842 for certain entities due to COVID-19.
- ▶ ASU 2021-05, Leases (Topic 842): Lessors—Certain Leases with Variable Lease Payments, to address the recognition of a day-one loss issue by lessors in certain leases.
- ▶ ASU 2021-09, Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities, to permit election of the risk-free discount rate by asset class, rather than for all leases.
- ▶ ASU 2023-01, Leases (Topic 842): Common Control Arrangements, which simplifies the lease identification assessment of, and accounting for, common control arrangements for nonpublic entities and changes how to amortize, and account for the transfer of, leasehold improvements in common control leases.

While the Blueprint does not include all requirements of ASC 842, it summarizes key aspects of ASC 842 that will commonly arise in applying ASC 842. It also includes practical examples and interpretive guidance to assist companies and practitioners in their adoption and continued application of ASC 842.

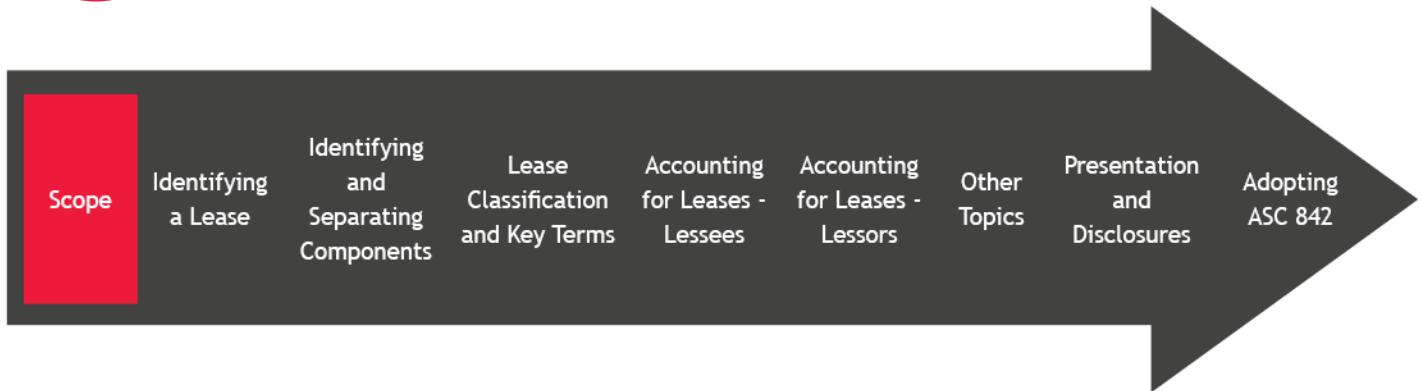
The Blueprint has been divided into chapters, which address key aspects of the new lease standard. These chapters are generally organized in the order in which an entity applies ASC 842, and the questions that an entity needs to answer as it proceeds through the evaluation. For example, the first chapter discusses whether a contract is within the scope of ASC 842, and if so, a reader moves to the next chapter that addresses whether the contract contains a lease, and so on. Other aspects of ASC 842 related to specific transactions and interactions with other areas of GAAP have been grouped into one chapter “Other Topics” which includes accounting for subleases, sale and leaseback transactions, business combinations, and income taxes. Finally, there is a detailed chapter discussing effective dates and how to transition to ASC 842.

The illustration below depicts how the chapters are organized. At the start of each chapter, the flowchart will be repeated, and your location in the overall flowchart will be identified.





# CHAPTER 1 – SCOPE



## 1.1 SCOPE AND SCOPE EXCEPTIONS

ASC 842 is limited to leases of property, plant, or equipment. Accordingly, it does not apply to any of the following:

| LEASED ASSET   | RELEVANT GUIDANCE AND OBSERVATIONS   |
|--|--|
| Leases of intangible assets, like licenses of IP   |  Apply ASC 350, Intangibles—Goodwill and Other  |
| Leases to explore for or use minerals, oil, natural gas, and similar nonregenerative resources |  Apply ASC 930, Extractive Activities—Mining, and ASC 932, Extractive Activities—Oil and Gas<br><i>The FASB clarified that the scope exception applies to the intangible right to explore for those natural resources and rights to use the land in which those natural resources are contained, unless those rights of use include more than the right to explore for natural resources. The scope exception does not apply to equipment used to explore for the natural resources. See Example 1 below for an illustration.</i> |
| Leases of biological assets, like plants and living animals                                    |  Apply ASC 905, Agriculture<br><i>Note that this scope exception includes timber to be consistent with ASC 840.</i>   |
| Leases of inventory  |  Apply ASC 330, Inventory   |
| Leases of assets under construction  |  Apply ASC 360, Property, Plant, and Equipment<br><i>Note that transactions in which the underlying asset needs to be constructed or redesigned for use by the lessee may be in scope of the sale-leaseback guidance if the lessee controls the asset under construction before the lease commencement date. See Chapter 7 for additional details.</i>  |

### BDO INSIGHTS – SCOPE OF ASC 842 CONSISTENT WITH ASC 840

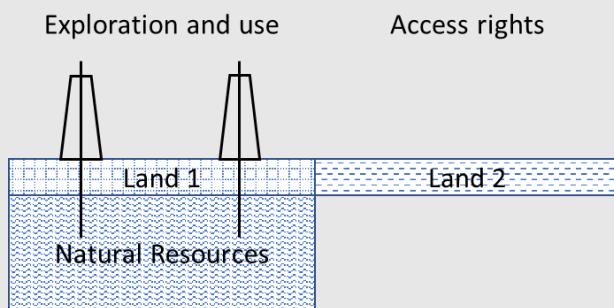
The scope of ASC 842 is generally consistent with the scope of the legacy lease guidance in ASC 840 and applies only to leases of property, plant or equipment (that is, land and/or depreciable assets). The Board acknowledged in paragraph BC110 in the Basis for Conclusions of ASU 2016-02 that the conceptual basis for excluding some other assets such as intangible assets, inventory and assets under construction from the scope of ASC 842 was unclear, but it nonetheless decided to continue to limit the scope to only property, plant or equipment for pragmatic reasons including cost-benefit reasons.

### BDO INSIGHTS – LONG TERM LEASES OF LAND NOT EXCLUDED FROM ASC 842

The scope of ASC 842 includes long-term leases of land, such as a 99-year lease of land. While some may view these long-term leases of land as economically similar to purchases of land, the Board noted that there is no conceptual basis for differentiating long-term leases of land from other leases and that any definition of “long-term” would be arbitrary in nature. Accordingly, those long-term leases of land are in the scope of ASC 842.

### EXAMPLE 1 - RIGHTS TO EXPLORE FOR OR USE NATURAL RESOURCES AND ADDITIONAL RIGHTS

Entity A obtains the intangible right to explore for or use natural resources along with rights to use the land that contains those natural resources (Land 1). To access Land 1 and explore for those natural resources, Entity A obtains access rights to an adjacent parcel (Land 2). The following picture summarizes Entity A's arrangements.



**Which of the above rights, if any, are outside the scope of ASC 842?**

ASC 842-10-15-1(b) states that the scope exception includes “the intangible right to explore for those natural resources and rights to use the land in which those natural resources are contained [...].” Accordingly, the intangible right to explore for or use natural resources along with rights to use Land 1 are outside the scope of ASC 842. This would be true even if Entity A entered into separate contracts with different parties for the rights to Land 1 and for the rights to explore for the underlying natural resources (for example, if the surface rights are legally separated from the mineral rights and are owned by different parties).

However, the scope exception does not apply to the rights to use Land 2 as the scope exception is limited to the rights to use the land in which the natural resources are contained and for which Entity A has exploration rights (i.e., which is Land 1 only). Accordingly, Entity A should determine whether its right to access or use Land 2 meets the definition of a lease. See also section below on specific considerations for land easements.

Note that if Entity A were also to lease (rather than own) the equipment used for the exploration or use of the natural resources (such as the drilling rigs in the picture above), those would be in the scope of ASC 842 and Entity A would need to determine whether its right to use the equipment meets the definition of a lease.

## 1.2 SPECIFIC CONSIDERATIONS FOR LAND EASEMENTS

Land easements (also commonly referred to as rights of way) represent the right to use, access, or cross another entity's land for a specified purpose. Easements are used in various industries, such as in the energy, utilities, transportation and telecom industries. For example:

- ▶ A midstream energy company might acquire a land easement for the right to pass a pipeline over, under, or through an existing area of land while allowing the landowner continued use of the land for other purposes (farming, hunting, etc.) if the landowner does not interfere with the rights of the midstream energy company.
- ▶ An electric utility might acquire a series of contiguous easements so that it can construct and maintain its electric transmission system on land owned by others.

Terms of land easements can vary greatly between agreements. For example, a land easement may be perpetual or term based, provide for exclusive or nonexclusive use of the land, may be prepaid or paid over a defined term, and so forth. The grantor (landowner) also may retain rights associated with access and use of the land area, or it may be restricted in its ability to access and use the land area.

Diversity in practice has historically existed in U.S. GAAP in the accounting for land easements before ASC 842. For example:

- ▶ Some entities have accounted for their land easements as intangible assets based on the guidance in Example 10 of ASC 350-30, Intangibles—Goodwill and Other—General Intangibles Other than Goodwill, which refers to land easements in that example as intangible assets.
- ▶ Some entities have applied ASC 360 and considered the prepaid land easement as a cost to bring property, plant or equipment (for example, a pipeline) to the condition and location necessary for its intended use.
- ▶ Some entities have applied ASC 840 (for example, a cell tower company entering into a land easement for the right to erect a communication tower).

Because of that diversity, in January 2018, the FASB issued ASU 2018-01, Land Easement Practical Expedient for Transition to Topic 842, to clarify that land easements are in the scope of ASC 842. However, considering the existing diversity in accounting and to reduce the cost and complexity associated with assessing whether all existing and expired land easements meet the definition of a lease for entities transitioning to ASC 842, ASU 2018-01 allows entities that previously did not account for land easements as leases under ASC 840 to elect a transition practical expedient to not assess those land easements under ASC 842 when adopting the new standard. Instead, entities will continue to account for those land easements under other GAAP unless the land easement is modified on or after ASC 842's adoption date. An entity that currently accounts for land easements as leases under ASC 840 cannot elect this practical expedient for those easements.

Because the Board clarified in ASU 2018-01 that land easements are in the scope of ASC 842, once an entity adopts the new lease standard, it must apply that guidance prospectively to all new or modified land easements to determine whether those arrangements meet the definition of a lease under ASC 842.

**BDO INSIGHTS – PRACTICAL EXPEDIENT PROVIDED FOR COST-BENEFIT REASONS**

Through outreach with stakeholders in industries most involved with land easements, the FASB learned that many land easements are perpetual (and therefore would not meet the definition of a lease because they are not “for a period of time”) and that many land easements are prepaid and therefore already recognized on the balance sheet. The Board therefore did not want entities to incur significant time and effort (considering the volume of land easements and age of those agreements) to evaluate them under ASC 842, especially considering that adoption of the new standard was generally not expected to have a material impact for these existing land easements.

While diversity in practice in accounting for land easements exists before ASC 842, it generally would be inappropriate for an entity to change its accounting policy prior to adoption of ASC 842 from accounting for those as leases under ASC 840 to accounting for those under ASC 350 or ASC 360.

**EXAMPLE 2 - LAND EASEMENTS IN TRANSITION**

Electric Company obtained a series of easements years before its adoption of ASC 842. The easements were obtained so that Electric Company could install poles to which its power lines would be attached. In addition to installing its poles, Electric Company has the right to access the poles via a corridor leading from the nearest road to the pole. Electric Company will make payments over time under the easement agreement in return for long-term access rights. Electric Company has historically accounted for those land easements along with its poles as property, plant and equipment under ASC 360.

Because Electric Company did not account for those land easements as leases under ASC 840, it can elect the practical expedient provided in ASU 2018-01. This means Electric Company will continue to account for those land easements under ASC 360 unless the agreement is modified on or after ASC 842’s adoption date, in which case Electric Company would need to assess whether those easements meet the definition of a lease under ASC 842. If elected, the practical expedient must be applied to all Electric Company’s land easements not accounted for as leases under ASC 840.

Alternatively, if Electric Company does not elect the land easements practical expedient, it should evaluate all of its existing land easements when adopting the new standard to determine whether those easements meet the definition of a lease under ASC 842.

**BDO INSIGHTS – UNIT OF ACCOUNT QUESTIONS ON LAND EASEMENTS AND SUBSURFACE RIGHTS NOT ADDRESSED**

As part of its project leading to the issuance of ASU 2018-01, the FASB became aware of several unit of account questions commonly arising with land easements impacting the lease evaluation under ASC 842. For example, a midstream energy company may acquire a land easement for the right to pass a pipeline under an existing area of land in which the landowner retains rights associated with the use of the land surface. In this example, a question arises as to whether the subsurface area represents its own unit of evaluation, or whether the subsurface and surface should be considered together when evaluating whether the contract contains a lease. This question is important as it is more likely that the arrangement would contain a lease if the subsurface is considered its own unit of evaluation. Despite those questions, the FASB decided not to provide additional clarity as it did not view these issues as being limited to land easements. If an entity determines that an arrangement does not contain a lease, it applies other GAAP such as ASC 350 or ASC 360 to account for the arrangement.

For arrangements similar to the midstream energy company example above, we believe that it would be acceptable for the entity to either apply ASC 842 and evaluate whether the arrangement contains a lease, or to analogize the subsurface rights to air rights (i.e., an intangible asset, which is outside the scope of ASC 842) to the extent the rights conveyed relate to subsurface (underground) space that cannot be inhabited or otherwise be accessed (which are characteristics shared with air rights). In the latter situation, the entity would not apply the definition of a lease in ASC 842 but would apply other GAAP such as ASC 350 to its arrangement. However, we do not believe that an analogy to air rights is acceptable in all cases. For example, it would be inappropriate for an entity to analogize to air rights for leases of underground retail space in a subway station, a basement of a commercial office building, or underground parking garage. Careful consideration should also be given when determining the appropriate accounting for land easements as terms and conditions may vary greatly between arrangements.

**BDO INSIGHTS – DIVERSITY IN ACCOUNTING WHEN A LAND EASEMENT IS NOT A LEASE NOT ADDRESSED**

When an entity evaluates a land easement under ASC 842 and determines it is not a lease, the diversity in accounting observed outside of the lease guidance is not addressed in ASU 2018-01. As previously discussed, some entities have applied ASC 350 while others have applied ASC 360. The FASB noted in paragraph BC11 of ASU 2018-01 that it did not intend to address diversity in the guidance applied when a land easement does not meet the definition of a lease. For example, consider an entity that accounts for its land easements as intangible assets before adoption of ASC 842 based on the guidance in Example 10 of ASC 350-30. If that entity enters into a land easement after adoption of ASC 842 but the contract does not include a lease, the entity's past practice of accounting for those arrangements as intangible assets is not affected by ASU 2018-01.

## 1.3 INTERACTION WITH OTHER STANDARDS

### 1.3.1 Derivatives and Hedging

ASC 815-10-15-79 on scope and scope exceptions to derivatives and hedging accounting explains that leases that are within the scope of ASC 842 are not derivative instruments subject to the guidance on derivatives and hedging. That is, a lease is not accounted for as a derivative instrument in its entirety. However, while not frequent, a derivative instrument embedded in a lease may be subject to the requirements of ASC 815-15-25 on recognition of embedded derivatives. In considering whether the derivative guidance must be applied to features embedded in a lease contract, an entity may consider the following guidance:

| FEATURE  | GUIDANCE   |
|--|--|
| Residual value guarantees                                | Residual value guarantees that are subject to the guidance in ASC 842 are not evaluated under the derivatives and hedging guidance. However, ASC 815-10-15-80 clarifies that a third-party residual value guarantor considers the guidance on derivatives for all residual value guarantees it provides to determine whether they are derivative instruments and whether they qualify for any of the scope exceptions in ASC 815-10 (such as the scope exception in ASC 815-10-15-59(b) on non-exchange traded contracts on nonfinancial assets).  |
| Inflation indexed rentals                                | Rentals for the use of leased assets and rent adjustments for inflation on similar property are generally considered clearly and closely related and, therefore, the inflation-indexed rentals typically do not require bifurcation. However, if there is a significant leverage factor involved, the inflation-indexed derivative instrument must be separated from the lease host contract. See Section 4.4 for further discussion.  |
| Variable lease payments based on variable interest rates | An obligation to make future payments for the use of leased assets and payment adjustments for changes in a variable-interest-rate index are generally considered clearly and closely related and, therefore, variable lease payments based on changes such as the prime rate do not typically require bifurcation from the lease host.  |
| Variable lease payments based on related sales           | Variable lease payments based on certain sales of the lessee are not separated from the lease host contract based on the derivative scope exception in ASC 815-10-15-59(d) on non-exchange traded contracts whose underlying is specified volumes of sales by one of the parties to the contract.  |
| Purchase options on underlying asset                     | A lessee purchase option embedded in a lease contract may not need to be separated from the lease host contract if the conditions for the derivative scope exception in ASC 815-10-15-59(b) on non-exchange traded contracts are met (for example, purchase option on real estate in an operating lease). Alternatively, if the scope exception does not apply, the purchase option may not be separated if there are no net settlement provisions in the lease contract (that is, gross settlement is required through payment of cash by the lessee and delivery of the underlying asset by the lessor), the contract cannot be readily net settled by means outside of the contract and the asset is not readily convertible to cash, which would usually be the case for real estate or equipment. |

### 1.3.2 Service Concession Arrangements

ASC 853-10-25-2 notes that the infrastructure that is the subject of a service concession arrangement within the scope of ASC 853 should not be recognized as property, plant, or equipment of the operating entity and that those service concession arrangements are not within the scope of ASC 842.

### 1.3.3 Revenue From Contracts With Customers

ASC 606-10-55-68 notes that if an entity has an obligation or a right to repurchase the asset (a forward or a call option), a customer does not obtain control of the asset because the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset even though the customer may have physical possession of the asset. That paragraph also notes that if the entity can or must repurchase the asset for an amount that is less than the original selling price of the asset, the entity accounts for the contract as a lease (unless the contract is part of a sale-leaseback transaction). If the contract is part of a sale and leaseback transaction, the entity should account for the contract as a financing arrangement and not as a sale and leaseback transaction in accordance with ASC 842-40.

### 1.3.4 Research and Development

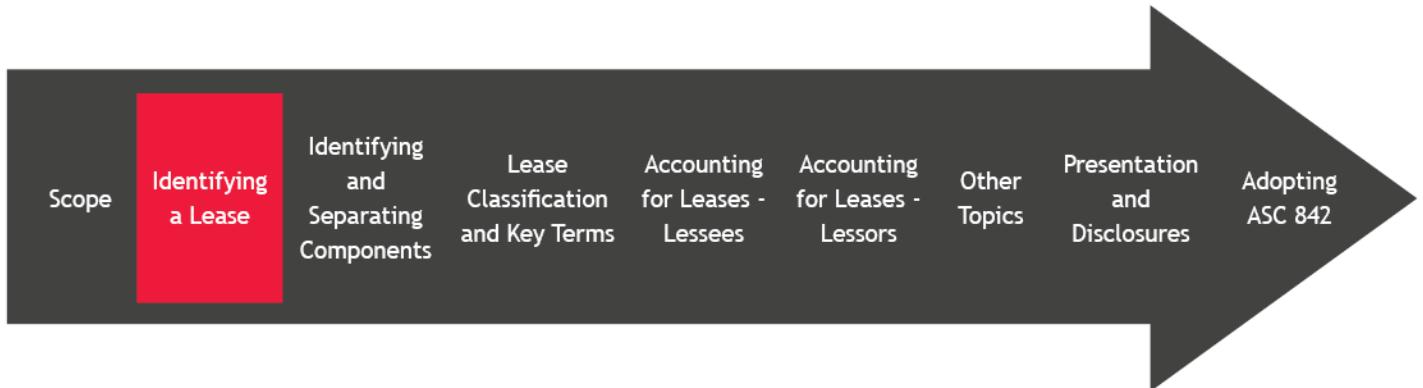
A lessee may enter into a lease for research and development (R&D) activities where the ROU asset has no alternative future uses in other R&D projects or otherwise.<sup>4</sup> In these scenarios, the accounting for the lease liability is unchanged (that is, it continues to represent an obligation that the lessee reports on its balance sheet). However, we believe the accounting for the ROU asset depends on lease classification. See Section 5.5.2.2 for further discussion.

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<sup>4</sup> See discussion on evaluation of alternative future uses in Chapter 3 of the AICPA's Accounting and Valuation Guide: *Assets Acquired to Be Used in Research and Development Activities*.



# CHAPTER 2 – IDENTIFYING A LEASE



## 2.1 OVERVIEW

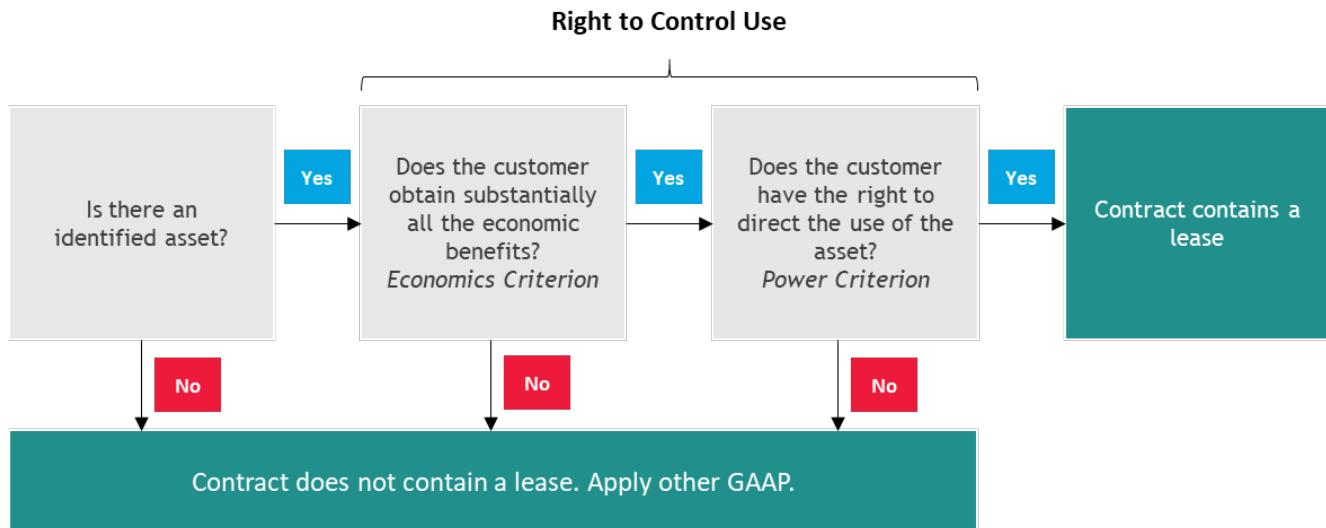
The Master Glossary defines a lease as a contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration.

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

A contract is or contains a lease if there is an identified asset and the contract grants the customer throughout the period of use both:

- ▶ The right to obtain substantially all of the economic benefits from the asset's use (the economic criterion), and
- ▶ The right to direct the use of the identified asset (the power criterion).

Accordingly, the definition of a lease focuses on three criteria as described in the following flowchart:



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



### CAREFULLY EVALUATE CONTRACTS WITH NO STATED CONSIDERATION

A contract that provides for the right to use an identified asset for no consideration is not a lease under ASC 842. However, all facts and circumstances should be considered. For example, if there is no stated cash consideration but the customer is required to provide goods or services to the supplier in exchange for the right to use the identified asset, there is noncash consideration and there may be a lease if the lease identification requirements discussed in this Chapter are met.

Also, for an entity to appropriately evaluate the three criteria in the above flowchart, it is important to understand the following:

- ▶ The contract must be for a period of time (See Example 1), and
- ▶ The evaluation of whether a contract is or contains a lease is performed based on the period of use, which is the total period of time an asset is used to fulfill the contract with the customer, including the sum of any nonconsecutive periods of time. That period is not always the contract term (See Example 2). Once determined, this period of use is applied to evaluate whether supplier substitution rights are substantive, and whether the economics and power criteria are met. Accordingly, it is a key concept of the evaluation.

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

The evaluation of whether a contract contains a lease is performed at contract inception, and an entity does not subsequently reassess its conclusion unless the terms and conditions of the contract are modified.

#### EXAMPLE 1 - CONTRACT MUST BE FOR A PERIOD OF TIME - PERPETUAL LAND EASEMENT

Electric Company obtained a series of easements from Southern Railroad after its adoption of ASC 842 (see Chapter 1 on scope for a practical expedient available in transition for certain land easements). The easements were obtained so that Electric Company could install poles to which its power lines would be attached. In addition to installing its poles, Electric Company has the right to access the poles via a corridor leading from the nearest road to the pole. Electric Company made an upfront payment under the easement agreement in return for perpetual access rights.

In this example, the agreement does not contain a lease. ASC 842-10-15-3 states that a lease conveys the right to control the use of identified property, plant or equipment *for a period of time* in exchange for consideration. The fact that the contract is perpetual means that it is not for a period of time, and, therefore, the agreement does not contain a lease. This view is consistent with conforming amendments made to the intangible assets' guidance in ASU 2018-01. Specifically, Example 10 of ASC 350-30 (paragraph 350-30-55-30) was amended to clarify that the perpetual easements that the entity owns were "evaluated under Topic 842 and determined to not meet the definition of a lease under that Topic (because those easements are perpetual and, therefore, do not convey the right to use the underlying land for a period of time)."

#### EXAMPLE 2 - PERIOD OF USE - CUSTOMER USES ASSET DURING NONCONSECUTIVE PERIODS

Calendar Co. sells calendars and holiday merchandise. In order to sell its products, it enters into a contract for the right to use a storefront in a mall for the months of November and December each year for five years.

Calendar Co. considers the "period of use" as defined in ASC 842-10-20 as "[t]he total period of time that an asset is used to fulfill a contract with a customer (including the sum of any nonconsecutive periods of time)." Because the periods of time are not consecutive, Calendar Co. must consider the aggregate term for which it has the right to use the storefront. In this example, the period of use is ten months (two months per year for five years); it is not the five-year contract term. Accordingly, the evaluation of whether the contract contains a lease considers the ten-month period that the storefront is used to fulfill the contract.

## 2.2 IDENTIFIED ASSET

### 2.2.1 General Considerations

An asset is typically identified when it is either explicitly specified in the contract, or implicitly specified when the asset is made available for use by the customer. Importantly, paragraph BC128 of ASU 2016-02 notes that “when assessing whether there is an identified asset, an entity does not need to be able to identify the particular asset that will be used to fulfill the contract to conclude that there is an identified asset. Instead, the entity simply needs to know whether an asset is needed to fulfill the contract from commencement. If that is the case, an asset is implicitly specified.”

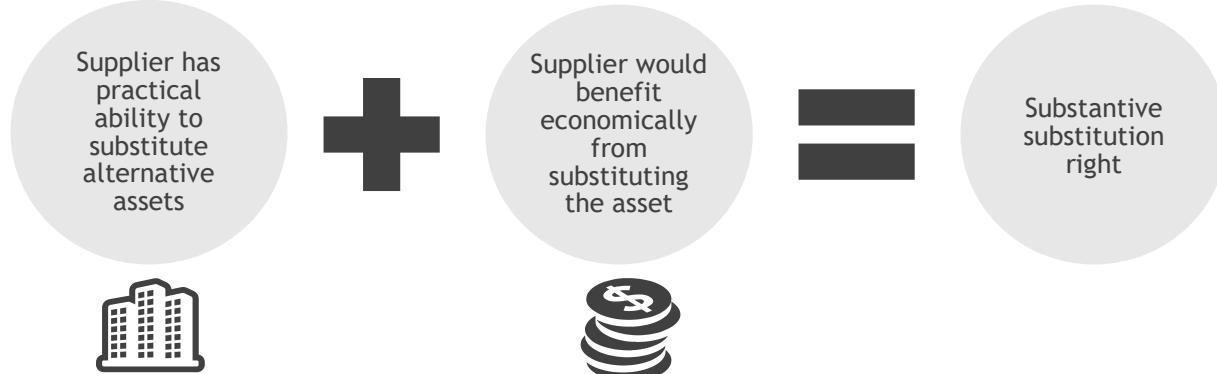
A capacity portion of an asset also can be an identified asset if it is physically distinct (for example, a floor of a building). A capacity or other portion of an asset that is not physically distinct is not an identified asset unless it represents substantially all of the capacity of the asset and thereby provides the customer with the right to obtain substantially all of the economic benefits from use of the asset. The following examples illustrate this requirement (assume for now that there are no supplier substitution rights).

| PHYSICALLY DISTINCT ASSET   | CAPACITY PORTION OF ASSET   |
|---|---|
| A customer enters into a 15-year contract with a supplier for the right to use 3 of 10 specific strands of a fiber optic cable connecting Paris and London. | A customer enters into a 15-year contract with a supplier for the right to use a specified amount of capacity (95%) within a cable connecting Paris and London. The specified amount is equivalent to the customer having the full capacity of 14 fiber strands within a 15-strand cable. |
| The strands of fiber optic cable are distinct from one another. Each strand is an identified asset.   | The capacity specified is not physically distinct, but it represents substantially all the capacity of the cable.<br><b>The cable is an identified asset.</b>   |

### 2.2.2 Supplier Substitution Rights

Even if an asset is specified, there is no identified asset if the supplier has the substantive right to substitute the asset throughout the period of use. That is, when a supplier substitution right is considered substantive, the supplier (rather than the customer) controls the use of the asset.

Supplier substitution rights are considered substantive when the following two conditions are met **throughout the period of use:**



The evaluation of supplier substitution rights is key because if it is determined that the supplier right is substantive, then there is no identified asset and thus the contract does not contain a lease.



A supplier has the practical ability to substitute alternative assets when, for example, the customer cannot prevent the supplier from exercising its right of substitution and the supplier has other alternative assets readily available (or the supplier could source alternative assets within a reasonable period of time).



A supplier would benefit economically from substituting the asset if the economic benefits of doing so exceed the related costs of substitution (e.g., transportation, installation costs, etc.). ASC 842 further states that if the asset is located at the customer's premises, the costs of substituting the asset are generally higher than when located at the supplier's premises, and therefore are more likely to exceed the related benefits. If the supplier costs to substitute exceed the related benefits, the substitution right is not substantive and, therefore, there is an identified asset.

ASC 842 provides additional guidance to evaluate whether supplier substitution rights are substantive.

| FACT PATTERN   | CONCLUSION   |
|--|--|
| Supplier can substitute the asset only in circumstances that are unlikely to occur at contract inception (for example, an agreement with a future customer to pay an above-market price for use of the asset). | Substitution right is not substantive.   |
| Supplier can substitute the asset only on or after a specified future date or specified event.   | Substitution right is not substantive because the supplier does not have the right to substitute the asset <i>throughout the period of use</i> . |
| Supplier can substitute the asset for repairs and maintenance or based on the availability of a technical upgrade.   | Substitution right is not substantive.   |
| Customer cannot readily determine whether a substitution right is substantive (for example, a customer may not have information about the supplier's costs of substitution).                                   | Customer must presume that the substitution right is not substantive (that is, there is an identified asset).                                    |

#### BDO INSIGHTS – SUBSTITUTION RIGHT REQUIREMENTS SET A HIGH HURDLE

The FASB provided guidance to determine when a supplier substitution right is substantive, in which case there is no identified asset and therefore no lease. To conclude that a supplier substitution right is substantive, based on the first sentence in ASC 842-10-15-10 the supplier must have the practical ability plus an economic opportunity to substitute the asset **throughout** the period of use (as explained in Section 2.1), rather than during **any** part of that period of use. For example, the supplier would not have a substantive substitution right if the supplier could benefit economically from substitution only during certain portions of the period of use (such as in the last nine months of a 10-year period of use, or starting in Year 3 of that period of use) or if it has the practical ability to substitute the asset but has the right to do so only during certain portions of that period of use (such as if the supplier can substitute the asset only when the specified asset is not being operated by the customer and is in a workshop for scheduled maintenance and inspection).

In April 2023, the IFRS Interpretations Committee issued an agenda decision on the evaluation of substitution rights. In response to the submitted question, the IASB staff noted that the requirements on substitution rights "set a high hurdle for a customer to conclude that there is no identified asset when an asset is explicitly or implicitly specified." In addition, entities should use judgement to determine whether a substitution right is substantive. In discussing the example in IFRS 16.B14(a), the Interpretations Committee observed that specifying that a supplier has the practical ability to substitute alternative assets throughout the period of use even if it does not already have alternative assets but could source those assets within a reasonable period of time "illustrates that the term 'throughout the period of use' does not mean at all times within that period."

Considering IFRS 16 and ASC 842 guidance are converged on lease identification, we believe the Interpretations Committee observations equally apply to U.S. GAAP.

**BDO INSIGHTS – CONCEPT OF IDENTIFIED ASSET UNDER ASC 842 VERSUS ASC 840**

The concept of a lease contract being based on an identified asset is not new and existed in ASC 840. Under ASC 840 an asset could be explicitly specified or implicitly specified (for example, when the supplier owned or leased only one asset with which to fulfill its obligation to the customer/purchaser and it was not economically feasible or practicable for the supplier to perform its obligation through the use of alternative property, plant, or equipment). ASC 842 retains a similar concept on identifying an asset but is more explicit on the evaluation of supplier substitution rights, now requiring that the supplier benefit economically from substitution. Accordingly, more contracts may be leases under ASC 842, and this determination becomes more important under the new guidance due to the balance sheet implications for lessees.

**EXAMPLE 3A (ADAPTED FROM PARAGRAPH 842-10-55-52 THROUGH 55-54) - CONCESSION SPACE****FACTS**

- ▶ Retailer enters into a contract with Airport Operator for the use of a space in an airport terminal for a five-year period.
- ▶ Retailer owns and utilizes a booth that is easily transferrable to different boarding areas.
- ▶ Airport Operator has many areas in the terminal that are available and would meet Retailer's specifications. Airport Operator can at its sole discretion relocate Retailer to different boarding areas in the terminal throughout the period of use. Airport Operator also would incur minimal costs associated with changing the space that Retailer uses.

**ANALYSIS****Is there an identified asset? No**

Although the contract specifies that Retailer will utilize a specific space in the airport to operate its booth:

- ▶ There are several other similar areas that Retailer may be assigned to, which Airport Operator has the right to change, without Retailer's approval, throughout the period of use. That is, Airport Operator has the practical ability to substitute Retailer's space.
- ▶ The costs to move Retailer's booth are minimal, and substitution allows Airport Operator to use its airport space in the most effective way, for example by relocating Retailer to other boarding areas to meet changing circumstances. Those conditions are likely to occur at contract inception considering Airport Operator's historical experience, business and operations. That is, Airport Operator would benefit economically from substituting Retailer's space.

Accordingly, Airport Operator's substitution right is substantive.

**CONCLUSION**

The contract does not contain a lease.

**EXAMPLE 3B (ADAPTED FROM PARAGRAPH 842-10-55-63 THROUGH 55-71) - RETAIL SPACE****FACTS**

- ▶ Retailer enters into a contract with Airport Operator for the use of retail unit A for a five-year period. Retail unit A is part of a terminal with many retail units.
- ▶ Airport Operator can require Retailer to relocate to another retail unit in the terminal. In that case, Airport Operator is required to provide Retailer with a retail unit of similar quality and specifications as retail unit A and to pay for Retailer's relocation costs, including reimbursement for any leasehold improvements that cannot be relocated.
- ▶ Airport Operator would benefit economically from relocating Retailer only if a major new tenant were to decide to occupy a large amount of retail space at a rate sufficiently favorable to cover the costs of relocating Retailer and other tenants for the space that the new tenant would occupy. Although it is possible that those circumstances will arise, at contract inception it is not likely that those circumstances will arise, and whether such circumstances occur is highly susceptible to factors outside of Airport Operator's control.

**ANALYSIS**

Is there an identified asset? **Yes**

Retail unit A is explicitly specified in the contract, and Airport Operator's substitution right is not substantive because Airport Operator would benefit economically from substitution only in specific circumstances that at inception of the contract are not likely to occur. That is, Airport Operator's substitution right is not substantive and, therefore, there is an identified asset.

**CONCLUSION**

The analysis continues to determine whether Retailer has the right to control the use of retail unit A. See Section 2.3 for additional discussion.

**EXAMPLE 4A (ADAPTED FROM PARAGRAPH 842-10-55-48 THROUGH 55-51) - RAIL CARS****FACTS**

- ▶ Smith & Company (SmithCo) enters into an agreement with Freight Systems Limited (Freight) to transport a specified quantity of products by using a specified type of rail car in accordance with a stated timetable for a period of five years. The timetable and quantity of products specified are economically equivalent to SmithCo having the use of ten rail cars for five years.
- ▶ Freight has a large pool of similar rail cars that can be used to fulfill the requirements of the contract. The rail cars are stored at Freight's location when not in use.

**ANALYSIS**

Is there an identified asset? **No**

The rail cars used to transport SmithCo's products are not identified assets. Freight has the practical ability to substitute each rail car throughout the period of use without SmithCo's approval, and Freight would benefit economically from substituting each car because the costs to substitute, if any, would be minimal, and substitution allows Freight to use the cars in the most efficient way for the task, for example because cars are currently at a rail yard close to the point of origin. Those conditions are likely to occur at contract inception considering Freight's historical experience, business and operations. Accordingly, Freight's substitution right is substantive. Therefore, although SmithCo has the right to use the equivalent of ten rail cars for five years, Freight directs the use of those rail cars by determining which cars will be used for each particular delivery.

**CONCLUSION**

The agreement does not contain a lease.

**EXAMPLE 4B (ADAPTED FROM PARAGRAPHS 842-10-55-42 THROUGH 55-47) - RAIL CARS****FACTS**

- ▶ Smith & Company (SmithCo) enters into an agreement with Freight Systems Limited (Freight) under which Freight provides SmithCo with the use of ten rail cars of a particular type for five years. The contract specifies the rail cars, which are owned by Freight.
- ▶ The agreement provides certain limitations on what types of goods SmithCo can transport, such as hazardous materials or explosives, but otherwise, SmithCo has the right to determine whether the rail cars are used, and if so, where, when and which products are transported using the rail cars. When the rail cars are not in use, they are stored at SmithCo's property.
- ▶ If a particular car needs to be serviced or repaired, Freight is required to substitute a rail car of the same type. Otherwise, Freight cannot retrieve the rail cars during the five-year period of the contract other than on default by SmithCo.

**ANALYSIS**

Is there an identified asset? **Yes**

There are ten identified rail cars. Once the cars are delivered to SmithCo, they can only be substituted when they need to be serviced or repaired, which is not considered a substantive substitution right based on the guidance in paragraph 842-10-15-14.

**CONCLUSION**

The analysis continues to determine whether SmithCo has the right to control the use of the rail cars. See Section 2.3 for additional discussion.

**EXAMPLE 5 - CONTRACT FOR HOSTING ARRANGEMENT****FACTS**

- ▶ Bank Company (“Bank”) enters into a hosting arrangement with Regional Hosting Co. (“Regional Hosting”) under which Regional Hosting will provide a specific number of servers on which it will host software licenses owned by Bank. In addition, Regional Hosting will provide connectivity to allow Bank to access the software hosted by Regional Hosting.
- ▶ Because of the number of users in Bank’s environment and the complexity of the software environment, Regional Hosting must host Bank’s software on dedicated servers with specific security requirements, and no other customer can be hosted on the same servers. However, Regional Hosting has the right to rehome Bank’s software onto different servers with similar security requirements without Bank’s approval so long as access to its software licenses is uninterrupted.

**ANALYSIS**

Is there an identified asset? No (Regional Hosting), Yes (Bank)

Regional Hosting considers whether its arrangement with Bank contains identified assets (i.e., each server) and notes that:

- ▶ It has numerous servers that meet Bank’s security requirements and from which it can host Bank’s software. Bank cannot prevent Regional Hosting from switching servers so long as access to Bank’s software is uninterrupted. Accordingly, Regional Hosting concludes it has the practical ability to substitute Bank’s servers throughout the period of use.
- ▶ There are minimal costs to substitute servers, and Regional Hosting would benefit economically from substitution. Specifically, it is common for new hosting customers to be obtained, at which time Regional Hosting often reconfigures its server space. In addition, to maximize performance on its servers, Regional Hosting regularly adds or deletes servers and moves customers as needed. Accordingly, Regional Hosting concludes that its right of substitution is substantive.

Regional Hosting concludes that the contract does not include identified assets and thus is not a lease.

Bank, however, does not have visibility into Regional Hosting’s operations and business (including how many servers Regional Hosting has with similar security requirements and how many customers it serves). Therefore, it concludes pursuant to the guidance in paragraph 842-10-15-15 that Regional Hosting’s right of substitution is not substantive, which means the agreement includes identified assets.

**CONCLUSION**

Regional Hosting concludes that it does not have a lease.

Bank continues its evaluation to determine whether it has the right to control the use of each identified asset (i.e., each server). See Section 2.3 for additional discussion.

## 2.3 RIGHT TO CONTROL USE OF IDENTIFIED ASSET

Even if a contract includes an identified asset, a contract does not contain a lease unless the customer has the right to control the use of that asset, which is met when the customer has throughout the period of use both:

- ▶ The right to obtain substantially all of the economic benefits from the asset's use (the economics criterion), and
- ▶ The right to direct the use of the identified asset (the power criterion).

### BDO INSIGHTS – RIGHT TO CONTROL USE UNDER ASC 842 SIMILAR TO ASC 606 AND ASC 810

Although the right to control the use of an identified asset is not a new concept, the application in ASC 842 is different than in ASC 840. Specifically, under the guidance in ASC 840, a contract contained a lease if:

- ▶ The customer controlled the operation of the asset while obtaining more than a minor portion of the output of the asset,
- ▶ The customer controlled physical access to the asset while obtaining more than a minor portion of the output of the asset, or
- ▶ It was remote that any other party would receive more than a minor portion of the output of the asset and the price for the output was neither fixed per unit nor equal to the market price at time of delivery.

Accordingly, under ASC 840 a customer could have the right to control the use of an asset solely based on obtaining substantially all the output from that asset, assuming the contract is priced in a certain way. This criterion defined control based on a benefits element only. However, ASC 606 on revenue from contracts with customers and ASC 810 on consolidation define control based on a benefits element and a power element. Likewise, ASC 842 now requires a customer to have throughout the period of use not only the right to obtain substantially all the economic benefits from use of an asset (the economics criterion), but also the ability to direct the use of that asset (the power criterion). In other words, a customer must have decision-making rights over the use of the asset that give it the ability to influence the economic benefits derived from the asset's use. Without such decision-making rights, the customer has no more control over the use of an asset than any customer purchasing supplies or services. As a result, certain contracts that met the definition of a lease under ASC 840 (for example certain power purchase agreements) may no longer meet the definition of a lease under ASC 842.

### 2.3.1 Restrictions and Supplier Protective Rights

Both the economic and power criteria are evaluated within the defined scope of the customer's right to use the asset. Terms that limit the use of the asset a certain way (for example, specifying a maximum amount of usage of the asset) or that protect the supplier's interest in the asset (such as requiring the customer to follow industry-standard operating procedures, or requiring notification of changes in how or where the asset will be used) do not, in isolation, prevent the customer from having the right to direct the use of the identified asset.

Accordingly, the analysis should focus on what the customer can do within that scope of use of the asset. Consider the following examples:

|                              | CORPORATE JET   | COMMERCIAL TRUCK   | RETAIL UNIT   |
|------------------------------|---|--|---|
| Contract                     | Contract for the use of a corporate jet for a two-year period.  | Contract for the use of a commercial truck for a five-year period.   | Contract for the use of a retail unit within a larger mall for a five-year period.  |
| Defines the scope of use     | Restrictions within the contract limit the number of hours the jet can fly and/or which territories the aircraft can fly over.  | Restrictions within the contract limit the number of miles the truck can be driven, and customer cannot transport hazardous or explosive goods.  | Restrictions within the contract limit the hours of operations of the store from 10am to 10pm.  |
| But within that scope of use | Customer has exclusive use of the corporate jet and decides whether the aircraft flies, where and when the aircraft flies (subject to the limits) and whether to transport passengers and/or cargo. | Customer has exclusive use of the truck and decides where and when the truck will be used, how many miles (subject to the limit) and what cargo (other than explosives) it will transport. | Customer has exclusive use of the retail unit and decides when to open (subject to the limit), the mix of goods to sell, and at what price to sell the goods. |

In all the above examples, even though the contract includes restrictions or limitations on the use of the asset, the contracts would include a lease as further explained in the Economic Criterion and Power Criterion sections below.

### 2.3.2 Economic Criterion

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

ASC 842 clarifies that only the economic benefits arising from *use* of an asset should be considered when assessing whether a customer has the right to obtain substantially all economic benefits. In many cases, the evaluation will be straightforward. For example, when the customer has exclusive use of an identified asset, it typically obtains 100% of the economic benefits from use of that asset. This is true for the corporate jet, commercial truck, and retail unit examples previously presented in the Restrictions and Supplier Protective Rights section. However, in other situations this evaluation will require the use of professional judgment.

Economic benefits arising from ownership of an asset (for example, tax benefits from owning an asset) are excluded in the evaluation. This is because a lease does not convey ownership of an underlying asset, but instead conveys the right to use that asset. To illustrate this, consider a utility company (customer) that enters into a contract with a power company (supplier) to purchase all electricity produced by a specific solar farm. Supplier owns the solar farm and will receive tax credits related to its ownership of the solar farm. Customer will receive renewable energy credits related to the use of the farm. The following table summarizes the relevant outputs to consider in determining whether the customer obtains substantially all the economic benefits from use of the asset.

| INCLUDE  | EXCLUDE   |
|--|---|
| <ul style="list-style-type: none"> <li>▶ Electricity produced by the solar farm (customer),</li> <li>▶ Renewable energy credits because they relate to the <i>use</i> of the solar farm (customer).</li> </ul> | <ul style="list-style-type: none"> <li>▶ Tax credits because they relate to the ownership of the asset, not the use of the asset (supplier).</li> </ul> |

In the above example, the customer receives 100% of the economic benefits from use of the asset, and therefore the economic criterion is met. If, instead, the supplier was to receive the renewable energy credits, the entity should determine whether the customer obtains substantially all of the economic benefits from use of the solar farm, which may require the use of professional judgment.

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

#### BDO INSIGHTS – MEANING OF “SUBSTANTIALLY ALL”

In practice, the term “substantially all” is generally interpreted to be at or around 90% or more. This term is also used in the lease classification test (see paragraphs 842-10-25-2 and 25-3), and paragraph 842-10-55-2c notes that a reasonable approach is to conclude that 90% or more amounts to substantially all. That threshold also is mentioned in many other areas of U.S. GAAP and generally has been applied in a similar manner.

**EXAMPLE 3B - RETAIL SPACE (CONTINUED)****FACTS**

- ▶ Retailer enters into a contract with Airport Operator for the use of retail unit A for a five-year period. Retail unit A is part of a larger airport terminal with many retail units.
- ▶ Retailer is required to use retail unit A to operate its well-known store brand to sell its goods during the hours that the airport terminal is open.
- ▶ Retailer pays Airport Operator \$50,000 per month plus 6% of monthly net sales.

**ANALYSIS**

Is there an identified asset? Yes

See Section 2.2 for additional discussion.

Is the economic criterion met? Yes

Retailer has exclusive use of retail unit A and therefore obtains substantially all of the economic benefits from use of the retail unit throughout the period of use. Although Retailer will pay Airport Operator a portion of the cash flows derived from sales in retail unit A (i.e., 6% of monthly net sales), this represents consideration that Retailer pays to Airport Operator for the use of retail unit A and it does not affect the evaluation of the economic criterion in accordance with paragraph 842-10-15-19.

**CONCLUSION**

The analysis continues to determine whether Retailer has the right to direct the use of retail unit A. See Section 2.3.3 for additional discussion.

**EXAMPLE 4B - RAIL CARS (CONTINUED)****FACTS**

- ▶ Smith & Company (SmithCo) enters into an agreement with Freight Systems Limited (Freight) under which Freight provides SmithCo with the use of ten rail cars of a particular type for five years.
- ▶ The contract specifies the rail cars, which are owned by Freight. When the rail cars are not in use, they are stored at SmithCo's property.

**ANALYSIS**

Is there an identified asset? Yes

See Section 2.2 for additional discussion.

Is the economic criterion met? Yes

SmithCo has the right to obtain substantially all of the economic benefits related to the use of the rail cars over the five-year period of use because SmithCo has exclusive use of the cars during that period.

**CONCLUSION**

The analysis continues to determine whether SmithCo has the right to direct the use of the rail cars. See Section 2.3.3 for additional discussion.

**EXAMPLE 5 - CONTRACT FOR HOSTING ARRANGEMENT (CONTINUED)****FACTS**

- ▶ Bank Company (“Bank”) enters into a hosting arrangement with Regional Hosting Co. (“Regional Hosting”) under which Regional Hosting will provide a specific number of servers on which it will host software licenses owned by Bank. In addition, Regional Hosting will provide connectivity to allow Bank to access the software hosted by Regional Hosting.
- ▶ Because of the number of users in Bank’s environment and the complexity of the software environment, Regional Hosting must host Bank’s software on dedicated servers with specific security requirements, and no other customer can be hosted on the same servers.

**ANALYSIS**

Is there an identified asset? Yes (Bank), No (Regional Hosting)

See Section 2.2 for additional discussion.

Is the economic criterion met? Yes (Bank Only)

Regional Hosting must host Bank’s software on dedicated servers, which means no other customer can be hosted on those servers. Accordingly, Bank has exclusive use of the servers and therefore it obtains substantially all of the economic benefits from use of those servers.

**CONCLUSION**

The analysis continues to determine whether Bank has the right to direct the use of the servers. See Section 2.3.3 for additional discussion.

**EXAMPLE 6 (ADAPTED FROM PARAGRAPH 842-10-55-100 THROUGH 55-107) - CONTRACT FOR SHIRTS****FACTS**

- ▶ Brand X enters into an agreement with Contract Manufacturing Company (“CMC”) to purchase a particular type, quality and quantity of shirts for a three-year period. The type, quality and quantity of shirts are specified in the contract.
- ▶ CMC has only one factory that can meet the needs of Brand X and it is unable to supply the shirts from another factory or source the shirts from a third-party supplier. The capacity of the factory significantly exceeds the output for which Brand X has contracted.
- ▶ CMC makes all decisions about the operations of the factory, including the production level at which to run the factory and which customer contracts to fulfill with the output of the factory that is not used to fulfill Brand X’s contract.

**ANALYSIS**

Is there an identified asset? **Yes**

The agreement contains an implicitly specified asset because CMC can only fulfill the contract through the use of this factory.

Is the economic criterion met? **No**

Brand X does not have the right to obtain substantially all of the economic benefits from use of the factory. CMC could decide to use the factory to fulfill orders from other customers during the three-year term of the agreement, and the capacity of the factory significantly exceeds the output for which Brand X has contracted.

*Note that Brand X’s rights are also limited to specifying output from the factory in its contract, and it has only the same rights regarding use of the factory as do any other customers purchasing shirts or other products from the factory. CMC has the right to direct the use of the factory because it can decide how and for what purpose the factory is used. Accordingly, the power criterion also would not be met.*

**CONCLUSION**

The agreement does not contain a lease.

**EXAMPLE 7 - CONTRACT FOR GAS GATHERING****FACTS**

- ▶ Midstream Company (“Midstream”) owns and operates an oil and gas gathering system in a specific area within the Permian basin. Midstream enters into a gas gathering agreement with Oil & Gas Company (“O&G”) to provide gathering services for O&G in the area covered by Midstream’s gathering system for a period of 10 years. The pipeline lateral used to fulfill the contract is connected to Midstream’s integrated pipeline system.
- ▶ The contract provides Midstream with the exclusive right to receive, gather and transmit all gas produced by O&G in the area, and the system must always be available to transmit the gas produced by O&G. However, Midstream retains certain rights associated with the pipeline lateral. For example, Midstream can use the pipeline lateral to store other customers products, to use it for system balancing purposes, or to take advantage of market price fluctuations through park and loan services. Midstream also has the right to connect other pipelines to the pipeline lateral without O&G’s consent as long as Midstream continues to service the volumes produced by O&G.

**ANALYSIS**Is there an identified asset? **Yes**

The pipeline lateral is explicitly identified, and Midstream does not have an alternative asset that could be used to fulfill the contract. Paragraph 842-10-15-16 also describes “a segment of a pipeline that connects a single customer to the larger pipeline” as one example that is considered an identified asset.

Is the economic criterion met? **No**

Although Midstream’s system must always be available to transmit the gas produced by O&G, O&G does not have exclusive use of the pipeline lateral because Midstream has the right to use the pipeline for other purposes. The pipeline lateral can handle more capacity than the capacity requested by O&G and Midstream also can increase the capacity of the pipeline lateral through various mechanisms. Midstream has the right to use that excess capacity for its own economic benefits throughout the 10 years (for example, to store other customers’ products, for system balancing purposes, to take advantage of market price fluctuations through park and loan services, etc.) and those economic benefits are considered significant.

*Note that O&G also can only request that Midstream transports the quantity of gas that it produces and does not have the right to direct how and for what purpose the pipeline is used. Midstream retains the relevant decisions about the use of the pipeline lateral throughout the 10 years. Those decisions include whether to store other customers’ products or use excess capacity for other purposes, whether to connect additional pipelines, etc. Midstream makes those decisions throughout the 10-year contract. Accordingly, the power criterion also would not be met.*

**CONCLUSION**

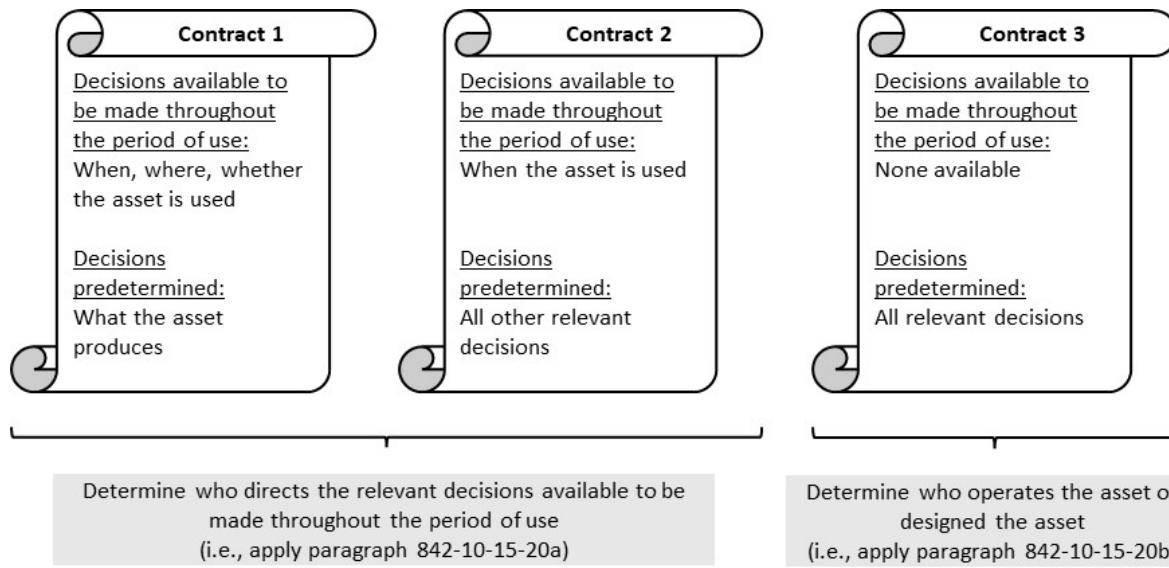
The agreement does not contain a lease.

### 2.3.3 Power Criterion

ASC 842-10-15-20 notes that the power criterion is met if:

- (a) The customer can direct how and for what purpose the asset is used throughout the period of use (i.e., the customer directs the relevant decisions during the period of use), or
- (b) When all relevant decisions are predetermined (such as by design of the asset or contractual restrictions), either:
  1. The customer has the right to operate (or direct others in operating) the asset throughout the period of use with the supplier having no right to change those operating instructions, or
  2. The customer designed the asset (or specific aspects of it) in a way that predetermined the relevant decisions throughout the period of use.

Determining which guidance in ASC 842-10-15-20 to apply (i.e., a or b above) is key. So long as there is at least one relevant decision to be made throughout the period of use, the guidance in (a) above should be applied. In other words, the guidance in (b) applies only in situations in which *all* relevant decisions are predetermined in the contract. We illustrate these considerations through the following scenarios:



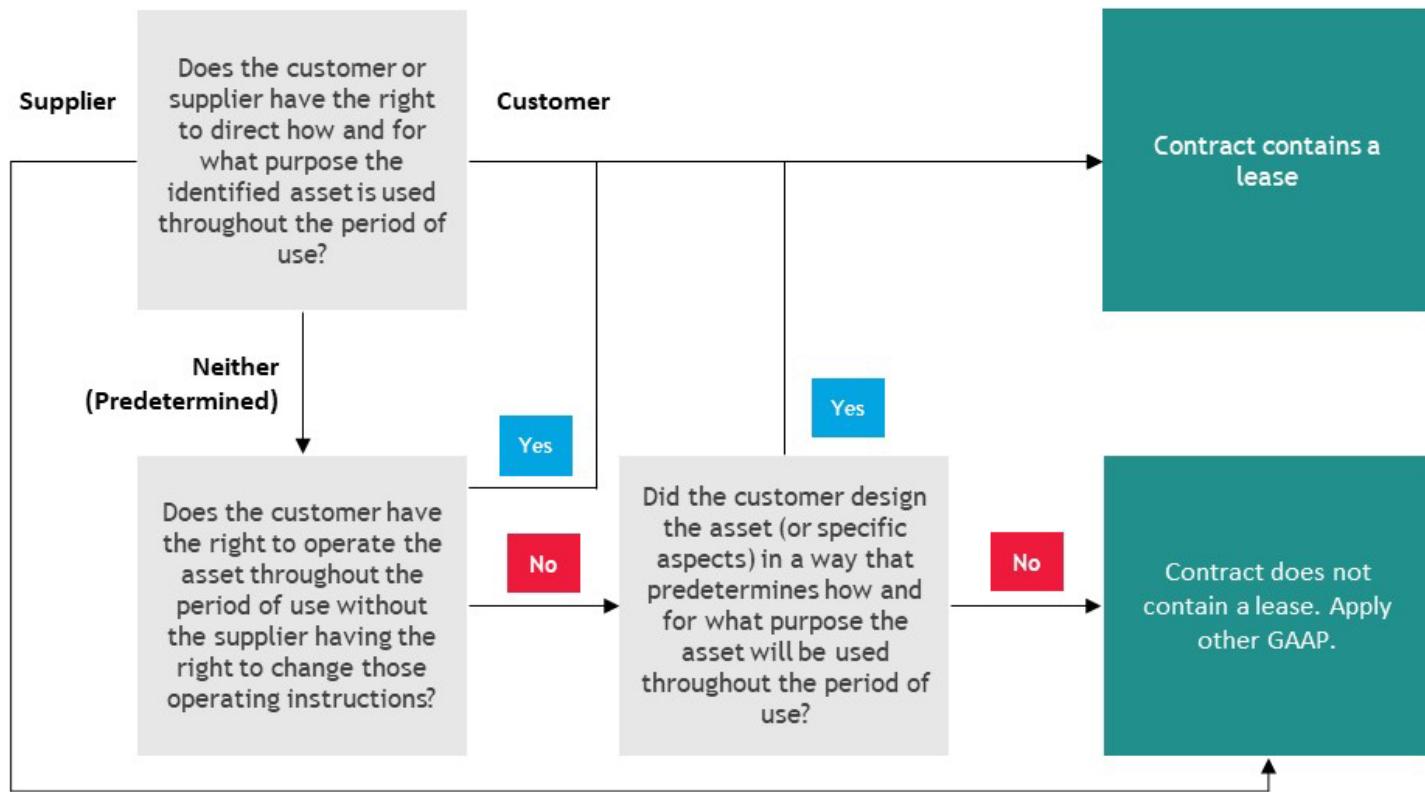
Accordingly, appropriately identifying the relevant decisions and determining whether those are predetermined or not will be important. Example of relevant decision-making rights to consider in the analysis include the following:

| EXAMPLE RELEVANT DECISIONS   | CORPORATE JET  | COMMERCIAL TRUCK   | RETAIL UNIT   |
|--|--|--|---|
| Right to change the type of output produced by the asset                       | Deciding whether to transport passengers and/or cargo.   | Deciding on the mix of goods to transport.   | Deciding on the mix of products sold in the retail store.   |
| Right to change when the output is produced                                    | Deciding when the aircraft flies.  | Deciding when the truck is used.   | Deciding when the retail store is open to customers.  |
| Right to change where the output is produced                                   | Deciding where the aircraft flies.   | Deciding where the truck will transport goods.   | Not applicable.   |
| Right to change whether the output is produced and how much output is produced | Deciding whether to fly the aircraft, how many times the aircraft flies in a specific period, and how much cargo to transport. | Deciding whether to use the truck, how many times the truck is used, and how much goods it transports. | Deciding whether to open the retail store, how long it is open, and how much goods to sell to customers during that period. |

These rights are examples only and are neither determinative nor prescriptive. For example, a requirement to use an asset in a specified location does not necessarily imply that the customer does not direct the use of the asset.

Example of decision-making rights that are not relevant include maintaining the asset or operating the asset (unless all relevant decision-making rights are predetermined). While a right to operate the asset is essential to the use of the asset, it is dependent on the decisions about how and for what purpose the asset is used. Accordingly, rights to maintain or operate the asset can be held by the customer or the supplier but typically will not affect the analysis. However, a right to operate the asset is a relevant decision when all relevant decision-making rights are predetermined.

The following flowchart summarizes the thought process for determining whether the customer has the right to direct the use of an identified asset, and whether there is a lease (assuming all other conditions are met).



**EXAMPLE 3B - RETAIL SPACE (CONTINUED)****FACTS**

- ▶ Retailer enters into a contract with Airport Operator for the use of retail unit A for a five-year period. Retail unit A is part of a larger airport terminal with many retail units.
- ▶ Retailer is required to use retail unit A to operate its well-known store brand to sell its goods during the hours that the airport terminal is open.
- ▶ Retailer makes all the decisions about the use of retail unit A during the period that the airport terminal is open (e.g., deciding on the mix of goods to sell, and at what price to sell the goods).
- ▶ Retailer pays Airport Operator \$50,000 per month plus 6% of monthly net sales.

**ANALYSIS**

Is there an identified asset? Yes

See Section 2.2 for additional discussion.

Is the economic criterion met? Yes

See Section 2.3.2 for additional discussion.

Is the power criterion met? Yes

The contractual restrictions on the types of goods that can be sold and when the store must be open define the scope of Retailer's use of retail unit A. Within that scope, Retailer makes the relevant decisions about how and for what purpose the space is used (for example, how much inventory to hold at the store, the mix of its goods to sell, the price of goods sold, etc.).

**CONCLUSION**

The contract contains a lease of retail space.

**EXAMPLE 4B - RAIL CARS (CONTINUED)****FACTS**

- ▶ Smith & Company (SmithCo) enters into an agreement with Freight Systems Limited (Freight) under which Freight provides SmithCo with the use of ten rail cars of a particular type for five years. The contract specifies the rail cars, which are owned by Freight.
- ▶ The agreement provides certain limitations on what types of goods SmithCo can transport, such as hazardous materials or explosives, but otherwise, SmithCo has the right to determine whether the rail cars are used, and if so, where, when and which products are transported using the rail cars. When the rail cars are not in use, they are stored at SmithCo's property.
- ▶ If a particular car needs to be serviced or repaired, Freight is required to substitute a rail car of the same type. Otherwise, Freight cannot retrieve the rail cars during the five-year period of the contract other than on default by SmithCo.

**ANALYSIS**

Is there an identified asset? Yes

See Section 2.2 for additional discussion.

Is the economic criterion met? Yes

See Section 2.3.2 for additional discussion.

Is the power criterion met? Yes

SmithCo has the right to direct the use of the cars throughout the five-year period of use. The contractual restrictions on the cargo that can be transported are protective rights of Freight and those define the scope of SmithCo's right to use the rail cars. Within that scope, SmithCo has the right to determine whether the rail cars are used, and if so, where, when and which products are transported using the rail cars.

**CONCLUSION**

The contract contains a lease of ten rail cars.

**EXAMPLE 5 - CONTRACT FOR HOSTING ARRANGEMENT (CONTINUED)****FACTS**

- ▶ Bank Company (“Bank”) enters into a hosting arrangement with Regional Hosting Co. (“Regional Hosting”) under which Regional Hosting will provide a specific number of servers on which it will host software licenses owned by Bank. In addition, Regional Hosting will provide connectivity to allow Bank to access the software hosted by Regional Hosting.
- ▶ Because of the number of users in Bank’s environment and the complexity of the software environment, Regional Hosting must host Bank’s software on dedicated servers with specific security requirements, and no other customer can be hosted on the same servers. However, Regional Hosting has the right to rehome Bank’s software onto different servers with similar security requirements without Bank’s approval so long as access to its software licenses is uninterrupted.
- ▶ Although Regional Hosting will provide monitoring services, Bank makes all decisions about which software to load onto the servers, and what types and how much data to transmit using the servers.

**ANALYSIS**

Is there an identified asset? Yes (Bank), No (Regional Hosting)

See Section 2.2 for additional discussion.

Is the economic criterion met? Yes (Bank Only)

See Section 2.3.2 for additional discussion.

Is the power criterion met? Yes (Bank Only)

Bank makes all decisions about which software to load onto the servers, and what types and how much data to transmit using the servers. Those are the relevant how and for what purpose decisions.

**CONCLUSION**

Bank concludes the contract contains a lease of the servers.

**EXAMPLE 8A (ADAPTED FROM PARAGRAPH 842-10-55-108 THROUGH 55-111) - SOLAR FARM****FACTS**

- ▶ County Electric Company (“CEC”) enters into a contract with Solar Power Co. (“Solar”) to purchase all of the electricity produced by a new solar farm for 20 years. The solar farm is explicitly specified in the contract, Solar has no substitution rights, and the energy cannot be provided from another asset.
- ▶ CEC designed the solar farm before it was constructed - CEC hired experts in solar energy to assist in determining the location of the farm and the engineering of the equipment to be used. Solar is responsible for building the solar farm to CEC’s specifications and then operating and maintaining it on a daily basis in accordance with industry-approved operating practices.
- ▶ Solar will receive tax credits related to the construction and ownership of the solar farm, while CEC receives renewable energy credits that accrue from the use of the solar farm.

**ANALYSIS**Is there an identified asset? Yes

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

Is the economic criterion met? Yes

CEC takes all the electricity produced by the farm, as well as receives the renewable energy credits that are a by-product from the *use* of the farm. Although Solar receives economic benefits from the solar farm in the form of tax credits, those credits relate to the *ownership* of the solar farm rather than from its *use*, and thus are not considered in the evaluation of the economic criterion. Accordingly, CEC receives 100% of the economic benefits from use of the solar farm.

Is the power criterion met? Yes

There are no decisions to be made during the period of use about whether, when, or how much electricity will be produced because the design of the asset has predetermined these decisions.

Although CEC does not operate the solar farm, its design of the farm has given it the right to direct the use of the farm. Because the design of the solar farm has predetermined how and for what purpose the asset will be used throughout the period of use, CEC’s control over that design is substantially no different from CEC controlling those decisions.

**CONCLUSION**

The contract contains a lease.

**EXAMPLE 8B (ADAPTED FROM PARAGRAPH 842-10-55-112 THROUGH 55-116) - SOLAR FARM****FACTS**

- ▶ Assume the same fact pattern as in Example 8A, except that Solar designed the solar farm when it was constructed prior to entering into the contract with CEC who was not involved in that design.

**ANALYSIS**

Is there an identified asset? **Yes**

Same as Example 8A.

Is the economic criterion met? **Yes**

Same as Example 8A.

Is the power criterion met? **No**

As in Example 8A, the relevant decisions about how and for what purpose the solar farm is used are predetermined. However, in contrast to Example 8A, CEC is not considered to direct the relevant decision-making rights about the use of the solar farm because it did not design the solar farm and it does not operate the solar farm. Solar designed the solar farm and operates it, and therefore Solar has the right to direct the use of the farm.

**CONCLUSION**

The contract does not contain a lease.

## 2.4 JOINT OPERATIONS OR ARRANGEMENTS

Joint operations or arrangements (“joint operations”) are common in certain industries such as oil and gas. For example, multiple parties may enter into a joint operation for the acquisition, development and operation of oil or natural gas properties. The parties to the joint operation typically enter into a joint operating agreement, or charter, that outlines the rights and obligations of each party to the arrangement, such as ownership (or working) interest of each party in the assets and cash flows of the joint operation and identification of the party (the operator) responsible for fulfilling the daily activities of the joint operation. The operator, on behalf of the joint operation, or the joint operation itself, also frequently enters into contracts with suppliers, such as contracts for the use of a drilling rig or a vessel, to fulfill the activities of the joint operation. In those situations, the evaluation of whether a contract includes a lease will depend on the facts and circumstances of the transaction, including which party is the customer in the contract with the supplier.

ASC 842-10-15-4 notes that in assessing whether a customer has the right to control the use of an identified asset, an entity considers whether the joint operation itself meets the economic and power criteria (see Sections 2.3.2 and 2.3.3 respectively) if the joint operation is the customer in the contract being assessed. A critical step in this analysis is therefore to determine which party (or parties) is the customer in the contract with the supplier (that is, which party has enforceable rights and obligations). In many cases, the operator enters directly into contracts with suppliers for the right to use the equipment and is considered the customer in the contract. But in some situations, the joint operation itself enters into the contract, or each party to the joint operation may be co-obligors in the arrangement with the supplier.

How the parties account for an arrangement that includes a lease will vary depending on which entity is the customer to the arrangement, as explained in the following table:

| OPERATOR IS THE CUSTOMER   | JOINT OPERATION IS THE CUSTOMER   |
|--|---|
| <ul style="list-style-type: none"> <li>▶ The supplier applies lessor accounting to its lease contract with the operator (see Chapter 6 on accounting for leases by lessors)</li> <li>▶ The operator as lessee recognizes 100% of the ROU asset and lease liability on its balance sheet (see Chapter 5 on accounting for leases by lessees)</li> <li>▶ The operator assesses whether a sublease of the asset to the joint operation exists (such as if the joint operating agreement or charter conveys the right to control the use of the underlying asset to the joint operation for a period of time through a governing body represented by each party to the joint operation), in which case the operator accounts for the sublease to each of the other parties in the joint operation as a sublessor (see Chapter 7 on other topics).</li> </ul> | <ul style="list-style-type: none"> <li>▶ The supplier applies lessor accounting to its lease contract with the joint operation (see Chapter 6 on accounting for leases by lessors)</li> <li>▶ ASC 842 does not provide specific recognition and measurement guidance for leases when the joint operation is the lessee (that is, when multiple unrelated parties are the customer or lessee)</li> <li>▶ If the parties are in the construction or extractive industry, each party may recognize an ROU asset and lease liability for its proportionate share or interest in the joint operation (assuming proportionate consolidation is appropriate; for example, see discussion in ASC 910-810-45-1, ASC 930-810-45-1 and ASC 932-810-45-1)</li> <li>▶ If specialized industry guidance does not apply, the entity’s accounting will depend on the facts and circumstances. In some cases, it may be appropriate to look to the guidance in ASC 405-40 on obligations resulting from joint and several liability arrangements.</li> </ul> |

## 2.5 COMMON CONTROL ARRANGEMENTS

Private company stakeholders raised concerns about ASC 842 application to common control arrangements (such as arrangements between sister entities controlled by a common owner). Concerns included determining whether a common control arrangement is or contains a lease based on the legally enforceable terms and conditions. For example, private companies adopting ASC 842 said challenges existed because the common control arrangements may be unwritten and, even when written, may be amended or not enforced by the common owner.

In response to those concerns, the FASB issued ASU 2023-01, Leases (Topic 842): *Common Control Arrangements*. ASU 2023-01 provides nonpublic entities<sup>5</sup> a practical expedient to use the written terms and conditions of a common control arrangement to determine whether a lease exists and, if so, to classify and account for that lease. Under the practical expedient, an entity assesses whether the written terms and conditions convey the **practical right** (rather than an enforceable right) to control the use of an identified asset for a period of time in exchange for consideration to determine whether a lease exists. If a lease exists, the entity classifies and accounts for the lease based on those written terms and conditions. The practical expedient may be applied on an arrangement-by-arrangement basis.

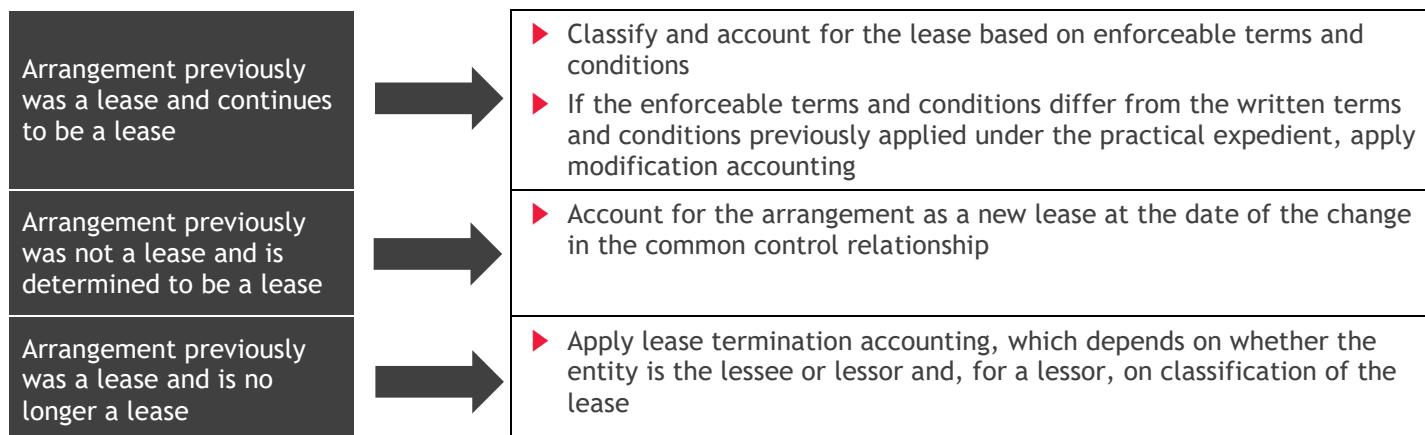
If no written terms and conditions exist, the entity cannot apply the practical expedient and it must use the enforceable rights and obligations to apply ASC 842 to the common control arrangement, like any arrangement between unrelated parties or related parties not under common control.

The following concepts are also important:

- ▶ Whether the entity applies the practical expedient or not, if the common control arrangement is not a lease, the entity applies other U.S. GAAP to account for both the arrangement and any improvements made by the customer to the supplier's asset. That is, improvements are recognized on a customer/lessee's balance sheet as leasehold improvements only when the arrangement is or contains a lease.<sup>6</sup>
- ▶ Applying the practical expedient does not eliminate the need for an entity to apply other relevant guidance in ASC 842 if the common control arrangement is or contains a lease. For example, an entity is still required to determine whether the arrangement contains lease and non-lease components (see Chapter 3) or to evaluate the lease term if there are lessee options to extend or not terminate the lease (see Section 4.3).

### Changes to Common Control Relationships

If, after applying the practical expedient, the common control relationship changes such that an arrangement is no longer between entities under common control, an entity uses the enforceable rights and obligations to determine whether a lease exists and follows the relevant accounting approach discussed below:



<sup>5</sup> Includes entities that are not public business entities (as defined in U.S. GAAP), not-for-profit entities that have issued or are conduit bond obligors for securities that are traded, listed or quoted on an exchange or an over-the-counter market or employee benefit plans that file or furnish financial statements with or to the U.S. Securities and Exchange Commission.

<sup>6</sup> BC16 and BC24 of the Update.

### BDO INSIGHTS - PRACTICAL EXPEDIENT CONSIDERATIONS

Similar to its decisions in previous projects, the FASB decided not to define “common control”. Instead, it noted that the term “common control” is used in other areas of U.S. GAAP. The FASB observed that an entity may refer to the SEC staff’s observations in Emerging Issues Task Force (EITF) Issue 02-5, *Definition of “Common Control” in Relation to FASB Statement No. 141*, acknowledging that private companies and most not-for-profit entities may apply a broader definition of common control.<sup>7</sup> We believe that an entity should apply the term “common control” consistently as an accounting policy election. Also, at a minimum, we believe common control arrangements include arrangements in which a controlling financial interest exists, as defined in ASC 810, *Consolidation*.

Nonpublic entities that elect to apply the practical expedient may need to set up new processes to periodically update the common control arrangement to make sure they can continue to use the expedient. For example, if the written terms and conditions are for a short lease term (for example, a one-month or a one-year lease), and those written terms and conditions expire, the entity will not be able to use the practical expedient and will need to evaluate the legally enforceable terms and conditions, like any other lease between unrelated parties or related parties not under common control.

Also, if the written terms and conditions allow the lessee to extend the one-month or the one-year lease at its option, or if the lease continues unless terminated by either party and the lessee would incur a significant penalty to terminate the lease (for example, because it would lose the benefit of significant leasehold improvements), the guidance in ASC 842 on determining the lease term applies, which may result in a lease term for accounting that is longer than the stated term.

Lastly, the FASB decided not to prescribe the documentation requirements necessary to use the practical expedient.<sup>8</sup> Rather, entities can use reasonable judgment to determine how terms and conditions of an arrangement are conveyed in writing. Therefore, we believe that a written document does not need to meet the legal definition of a contract to qualify for the practical expedient. For example, an email documenting the written terms and conditions of the arrangement may suffice, even if it does not include other clauses that generally appear in a legal contract.

For transition to ASC 842 related to existing common control arrangements, see Section 9.5.4.

<sup>7</sup> Basis for Conclusions (BC) 10 and BC11 of the Update.

<sup>8</sup> BC22 of the Update

## 2.6 OTHER ILLUSTRATIONS

The three concepts (identified asset, economic criterion and power criterion) are explored further through various additional examples below. Note that some of the examples may include nonlease components (which is discussed further in the next chapter on Identifying and Separating Components). The examples provided herein, and conclusions reached focus solely on whether the contract is or contains a lease.

### EXAMPLE 9 - CONTRACT FOR PRINTER

#### FACTS

- ▶ Paper Co enters into a contract with Printers R Us for the exclusive use of a copy machine for three years. Under the contract, the copier is explicitly specified by serial number, but Printers R Us has the right to replace the copier at any time during the agreement, including in lieu of repairing it, without Paper Co's approval.
- ▶ While the contract specifies a location for the copier, Paper Co has the right to move the copier to any of its facilities upon three days written notice to Printers R Us which approval cannot be unreasonably withheld, conditioned or delayed. Paper Co also has the right to decide when to use the copier and when it uses it, how many copies it makes (subject to a limit of 5,000 copies per month).

#### ANALYSIS

##### Is there an identified asset? Yes

Although Printers R Us has the right to replace the copy machine at any time and without Paper Co's approval, such substitution would likely not generate an economic benefit for Printers R Us. As noted in paragraph 842-10-15-12, if the asset is located at the customer's premises, then the costs associated with substitution are likely to exceed the benefits associated with substituting the asset. Specifically, in this example Printers R Us would incur costs to substitute the copy machine, such as employee time and costs of transporting and installing another copy machine and removing and transporting back the original copy machine. It is not likely that events or circumstances would arise at contract inception from which Printers R Us would generate more cash flows by substituting the copy machine than the costs it would incur. In addition, as noted in paragraph 842-10-15-14, rights to substitute identified equipment solely for repairs and maintenance are not substantive. Accordingly, Printers R Us' substitution right is not substantive and there is an identified asset.

##### Is the economic criterion met? Yes

Paper Co has the right to obtain substantially all of the economic benefits from the use of the copier because it has exclusive use of the copier.

##### Is the power criterion met? Yes

While Printers R Us has the right to approve before Paper Co can move the printer to another location, Printers R Us' right is protective in nature. The 5,000-copy limit per month also protects Printers R Us' copier and in effect defines the scope of the contract. Within that scope, Paper Co has the right to direct the use of the copier, including when to use it and for how long, how many copies to make (subject to the limit) and where to use it throughout the three-year period. Those decisions are the relevant decisions that impact the economic benefits from use of the copier.

#### CONCLUSION

Therefore, the contract contains a lease.

**EXAMPLE 10 - CONTRACT FOR SYRUP DISPENSERS AND SUPPLIES****FACTS**

- ▶ Pizzeria Co. enters into a syrup supply agreement with Beverage Co. under which Beverage Co. agrees to supply soft drink syrup to Pizzeria Co. for three years. In addition, Beverage Co. will provide dispensers that combine the syrup with CO<sub>2</sub> to deliver soft drinks to Pizzeria Co.'s customers.
- ▶ Pizzeria Co. is responsible for purchasing the CO<sub>2</sub> and for maintaining the dispensers, and the agreement prohibits Pizzeria Co. from using the dispensers with another supplier's syrup.
- ▶ Beverage Co. will provide two maintenance services per year per store to repair the dispensers at no charge, but additional maintenance visits will be charged on a time and materials basis.
- ▶ The contract stipulates a fixed monthly payment and a variable payment based on the volume of syrup purchased by Pizzeria Co.<sup>9</sup>

**ANALYSIS****Is there an identified asset? Yes**

While the agreement does not explicitly specify the individual beverage dispensers, the units are implicitly specified because the dispensers are required for Beverage Co. to fulfill its promise under the arrangement, and once installed, Beverage Co. has no right to substitute the installed equipment.

**Is the economic criterion met? Yes**

Pizzeria Co. has exclusive use of the beverage dispensers.

**Is the power criterion met? Yes**

Pizzeria Co. has the right to direct the use of the dispensers including determining when and how often to use them. The fact that the agreement prohibits Pizzeria Co. from using the dispensers with another supplier's products is a protective right that defines the scope of the contract but does not prevent Pizzeria Co. from controlling the use of the dispensers.

**CONCLUSION**

The contract contains a lease.

<sup>9</sup> Other contract types with only variable payments and the right, but not the obligation, for Pizzeria Co. to purchase syrup from Beverage Co. require careful consideration of the specific facts and circumstances, including the price at which the consumables are sold and the significance of the equipment in the context of the contract.

**EXAMPLE 11 - CONTRACT FOR SERVERS AND OTHER IT EQUIPMENT SPACE****FACTS**

- ▶ The owner of a co-location warehouse (“Co-Lo”) enters into an agreement with Software Company (“Software”) under which Software will install its servers and other IT equipment used to host and run its software platform.
- ▶ The agreement identifies specific space within the larger warehouse for Software to use, and indicates that Co-Lo does not have the right to relocate Software’s equipment once it is installed.
- ▶ The space that Software will occupy does not represent substantially all of the capacity of the warehouse. However, Software is required to install cages and other barriers that segregate its equipment from the rest of the warehouse, thus effectively physically segregating the space it is using.

**ANALYSIS**Is there an identified asset? Yes

Although the space is not initially a physically distinct portion of the larger warehouse and the space occupied does not represent substantially all of the capacity of the warehouse, the caging and other barriers required to be installed by Software render the space physically distinct and allow Software to control access to that specific space. In addition, Co-Lo has no ability to substitute comparable space throughout the term of the contract. Therefore, there is an identified asset.

Is the economic criterion met? Yes

Because Software has the right to control access to the specified space, it has the right to obtain substantially all of the economic benefits from use of the space (it has exclusive use of it).

Is the power criterion met? Yes

Software has the ability to make decisions about whether to use the space, and if so, when, how and how much to use the space.

**CONCLUSION**

The contract contains a lease.

**EXAMPLE 12 - CONTRACT FOR SMART SAFES****FACTS**

- ▶ EZ Co owns and operates a group of convenience stores. EZ Co enters into an agreement with State Bank in which State Bank will provide armored car services to EZ Co for three years.
- ▶ During the term of the contract, State Bank will collect cash and checks from each store location three times per week, and those dates and times are predetermined in the contract and cannot be changed absent emergency situations.
- ▶ Assume that the armored car services do not include a lease because State Bank serves many customers with the armored cars and therefore those are not the subject of this example.
- ▶ State Bank also provides one smart safe for each store location. Once installed at EZ Co's locations, State Bank cannot substitute the smart safe. The smart safe is connected electronically to State Bank's system and will transmit the value of cash and checks deposited into the safe to State Bank such that EZ Co receives credit in its bank account with State Bank within 24 hours of that deposit.
- ▶ Only State Bank has the right and ability to access the smart safes. Once an EZ Co employee deposits cash or checks into the safe, EZ Co cannot retrieve those items prior to State Bank's armored car service collecting them. However, EZ Co decides when to make deposits, as well as how much cash to deposit versus how much to retain for operating purposes.

**ANALYSIS**Is there an identified asset? Yes

Each smart safe is implicitly specified once it is installed at the convenience store location, and State Bank does not have any substitution rights.

Is the economic criterion met? Yes

EZ Co obtains substantially all of the economic benefits from use of the safes throughout the three-year period of use because it has exclusive use of those safes. No other customer of State Bank can use the safes.

Is the power criterion met? Yes

Although State Bank has the right to access the safes to collect the funds deposited in them, that access is predetermined in the contract (the dates and times are predetermined in the contract and cannot be changed absent emergency situations). The ability to access the safes also would not grant State Bank the right to determine how and for what purpose the safe is used given the fact that State Bank gives EZ Co access to funds deposited in the safe in EZ Co's bank account prior to the funds actually being collected by State Bank. On the other hand, EZ Co determines whether to use the safe, and if so, when to use it and how much cash and checks to deposit into the safe throughout the period of use. Those are the most relevant decision-making rights that affect the economic benefits from use of the safes, and EZ Co (the customer) controls them.

**CONCLUSION**

The contract contains a lease (each smart safe is a lease).

**EXAMPLE 13 - CONTRACT FOR OFFSHORE DRILLING RIG****FACTS**

- ▶ Big Oil Inc. (“BOI”) enters into an agreement with Drilling Company (“DrillCo”) whereby DrillCo will provide BOI with a specific offshore drilling rig for use in a specified geographical area in the Gulf of Mexico in which BOI has exclusive exploration rights. DrillCo has no other drilling rig in the Gulf of Mexico which could be used to fulfill the contract and DrillCo could not source another similar drilling rig within a reasonable period of time.
- ▶ DrillCo will provide the employees and management expertise necessary to operate the drilling rig. However, DrillCo will operate the rig under BOI’s instructions (for example, where to drill, how long to drill and at what depth, and where to drill next).
- ▶ The initial term of the agreement is two years and the agreement automatically renews for additional three-month periods unless either party provides a notice of non-renewal.
- ▶ During the period of the agreement, DrillCo will provide drilling services to BOI using the identified drilling rig.

**ANALYSIS**

Is there an identified asset? **Yes**

The agreement specifies the drilling rig and DrillCo has no other rig which can be used to fulfill the contract or that DrillCo could source within a reasonable period of time.

Is the economic criterion met? **Yes**

BOI receives substantially all of the output from use of the drilling rig because it has exclusive use of the rig. DrillCo cannot use the rig to provide services to any other customer during the term of the agreement, both contractually and practically, because BOI has exclusive exploration rights in that geographical area.

Is the power criterion met? **Yes**

Although DrillCo operates the drilling rig, and operating the rig is essential to the efficient use of the rig, the right to operate the rig is *dependent on* the relevant how and for what purpose decisions the rig is used (which are where to drill, how long to drill and at what depth, and where to drill next, etc.). BOI is the party that controls those relevant decisions throughout the period of use.

**CONCLUSION**

The contract contains a lease.

**EXAMPLE 14 - CONTRACT FOR PROCESSING RETURN OF HANDSETS****FACTS**

- ▶ Telco enters into an agreement with Logistics Company which requires Logistics Company to build a warehouse in a specified geographic area. Logistics Company is the legal owner of the warehouse and continues to be throughout the term of the contract.
- ▶ Assume that the agreement does not result in Telco controlling the warehouse under construction based on the guidance in paragraph 842-40-55-5.
- ▶ While Logistics Company has some latitude in selecting the location of the warehouse, it must be located in the specified area, and once constructed it cannot be relocated or substituted, even within the specified area, absent extraordinary circumstances (for example, destruction by fire).
- ▶ For the five-year term of the agreement, Logistics Company will process all returned handsets directed by Telco to this warehouse pursuant to repair instructions provided by Telco. If Telco does not direct handsets to the warehouse, then the warehouse does not operate. Logistics Company is not allowed to service any customers other than Telco in the warehouse under the agreement.
- ▶ Logistics Company is required to operate and maintain the warehouse daily in accordance with industry-approved operating procedures.

**ANALYSIS**Is there an identified asset? Yes

Once the location is selected and the warehouse constructed, Logistics Company does not have the right to substitute the specified warehouse location.

Is the economic criterion met? Yes

If Telco does not direct handsets to the warehouse, the warehouse does not operate because Logistics Company is not allowed to service other customers. In other words, Telco has exclusive use of the warehouse.

Is the power criterion met? Yes

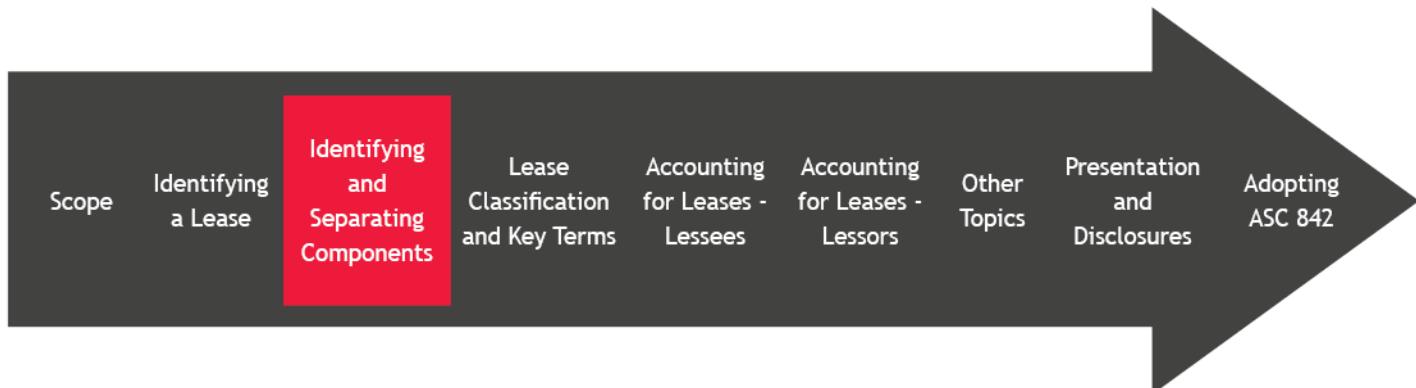
Telco makes the relevant decisions about how and for what purpose the warehouse is used because it has the right to determine whether, when and how many handsets are processed in the warehouse. Because Logistics Company is precluded from using the warehouse for any other customer or purpose, Telco's decision making about the timing and quantity of handsets processed in effect determines whether and when the warehouse will be utilized.

**CONCLUSION**

The contract contains a lease.

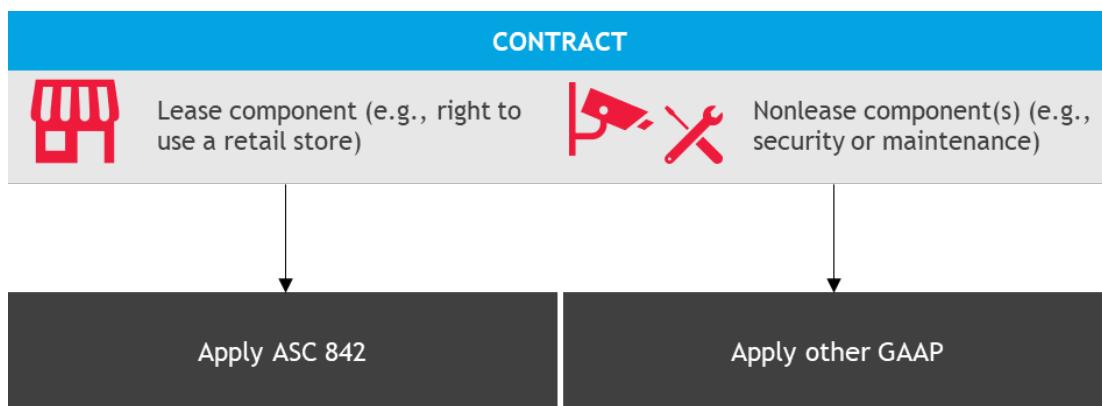


# CHAPTER 3 – IDENTIFYING AND SEPARATING COMPONENTS



## 3.1 OVERVIEW

In Chapter 2, we discussed how to identify a lease. Once an entity concludes that a contract is or contains a lease, the next step is to identify the components of the contract. Those components are the units of account that determine which GAAP applies, and they only include those items or activities that transfer a good or service to the lessee. The definition of a lease is based on the right to use an identified asset and, therefore, the lease component typically represents the right to use that identified asset (such as the right to use a retail store). A contract may also include one or more nonlease components (such as maintenance or security services for that retail store). In that scenario, the lease component is accounted for under ASC 842, while the nonlease component(s) are generally accounted for under other GAAP.



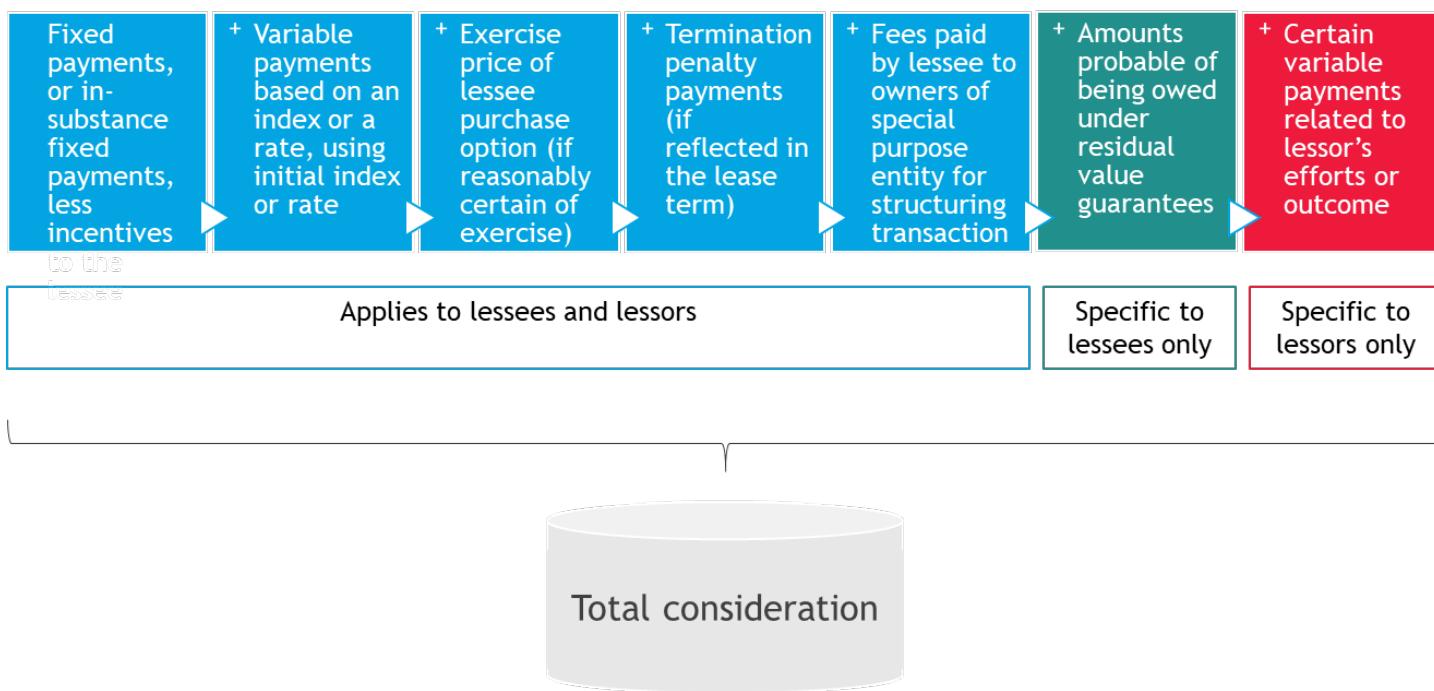
A contract may also include the lease of more than one asset. In those situations, the entity should evaluate how many lease components there are. Generally, the right to use each individual asset represents a separate lease component. For example, in a contract for the right to use two cars, each car represents a separate lease component, and the contract therefore includes two lease components. But sometimes leases of multiple assets are accounted for as one lease component depending on how dependent and interrelated, they are to each other. There are also specific considerations for leases of land.

Some items or activities do not transfer a good or service to the lessee and, therefore, are not considered components of the contract. Those include:

- ▶ Administrative tasks to set up the contract,
- ▶ Cost that a lessor would incur in its role as a lessor or as owner of the underlying asset (e.g., property taxes for which the lessor is the primary obligor and insurance that protects the lessor's asset).

In addition to identifying the components of the contract, the entity must determine the consideration in the contract. It typically includes fixed payments (including in-substance fixed payments) less incentives to the lessee, and variable payments based on an index or a rate, measured using the index or rate at the commencement date. The consideration may also include other payments depending on the contract's terms, such as the exercise price of a lessee purchase option if reasonably certain of exercise, or termination penalties if the lease term reflects exercise of a lessee termination option. A lessee does not include variable payments other than those based on an index or a rate, while lessors sometimes must include certain variable payments that relate specifically to nonlease components.

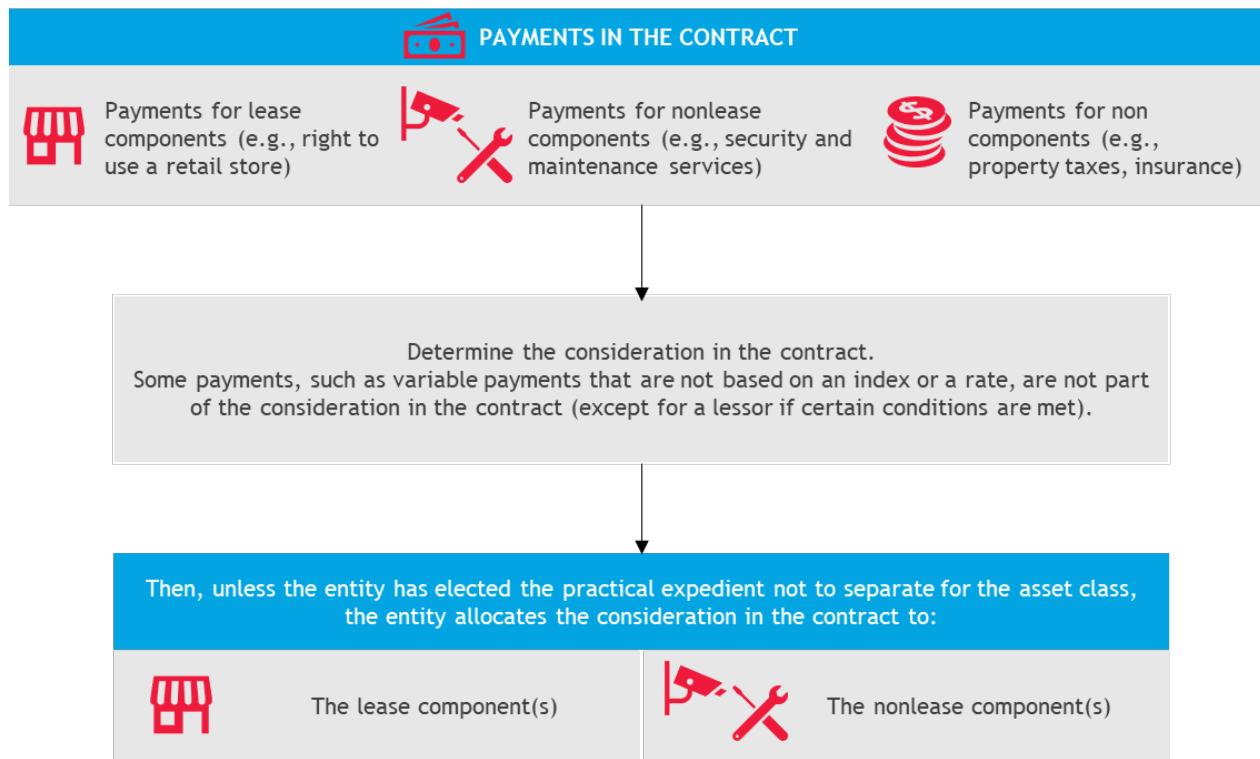
The following graph summarizes the consideration in the contract for lessees and lessors.



When a contract includes more than one lease component (for example, a contract with two lease components), or includes a lease component and at least a nonlease component, the entity typically must separate and allocate the consideration in the contract to those components, unless a practical expedient is elected (see below).

The allocation of the consideration is generally made on a relative standalone (selling) price basis, although lessors must apply the allocation guidance in ASC 606.

Also, items or activities that do not transfer a good or service to the lessee do not receive an allocation of the consideration in the contract because they are not considered components of the contract. This means that any payments in the contract for these items or activities, whether fixed or variable, will generally be allocated to the components of the contract as illustrated on the next page.



However, lessees and lessors can elect a practical expedient by asset class not to separate the nonlease component(s) from the associated lease component.

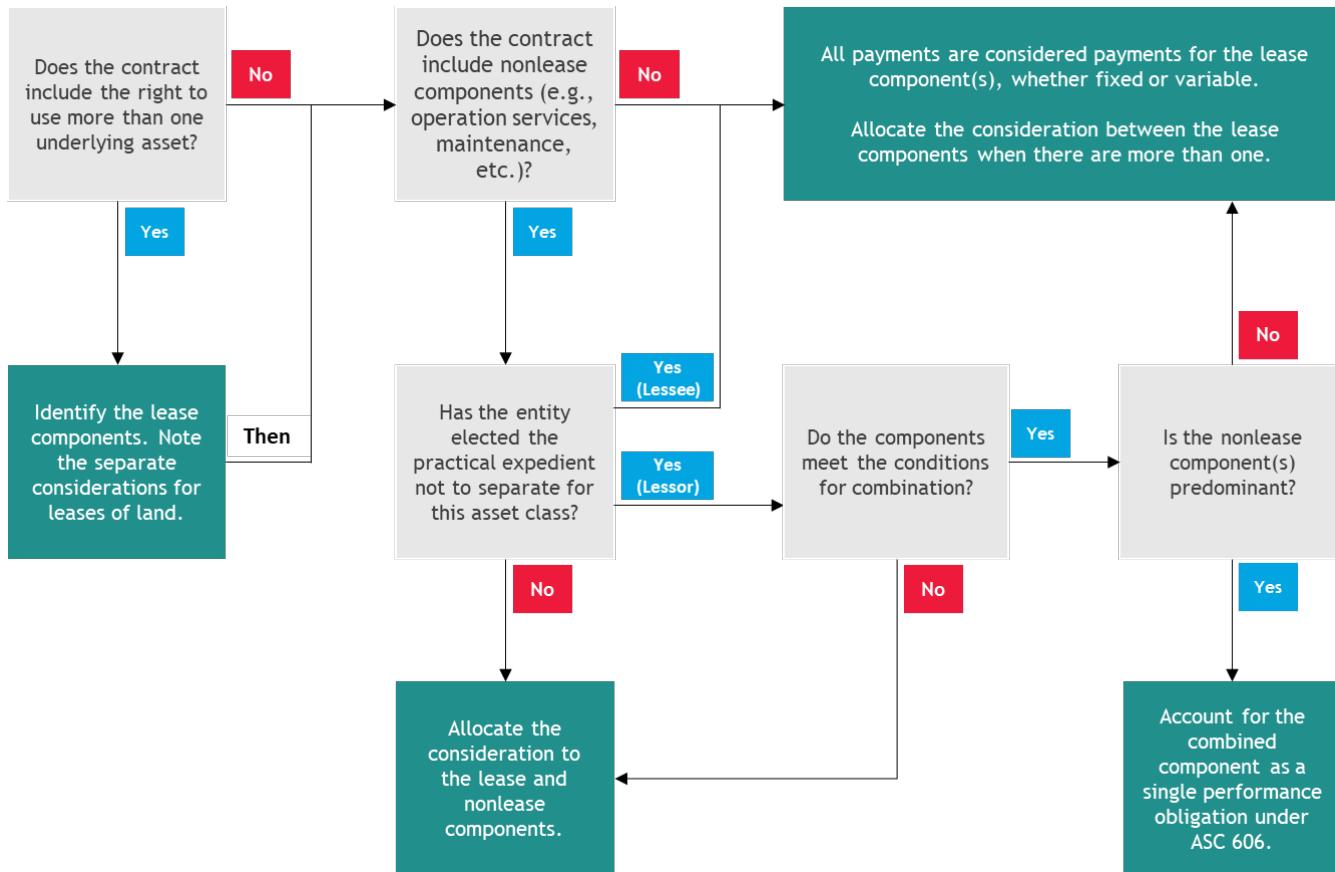
Lessees can generally apply the practical expedient without regard to conditions, and the combined component is accounted for under ASC 842.

Lessors may account for each separate lease component and the nonlease components associated with that lease component as a single lease component if the following three conditions are met:

- ▶ The nonlease component(s) otherwise would be accounted for under ASC 606,
- ▶ The timing and pattern of transfer of the lease component and nonlease component(s) associated with that lease component are the same, and
- ▶ The lease component, if accounted for separately, would be classified as an operating lease.

The accounting for the combined component then depends on which component of the contract is predominant which will dictate whether the lessor applies ASC 842 or ASC 606.

The following flowchart summarizes the key steps an entity should perform, which we will discuss in further details in this chapter.



Note that the above flowchart assumes that for a lessor, the nonlease component(s) in the contract will either meet the conditions to be combined with the lease component or won't. Sometimes, there may be nonlease components that meet the conditions, while some others don't. For example, a contract may include a lease of equipment, maintenance services related to that equipment, and a sale of consumables. In that situation, the lease component and maintenance services may meet the criteria to be combined, but the consumables will not because they are not provided over time. Therefore, if the lessor elected the practical expedient for the asset class, the lessor should allocate the consideration in the contract between the combined component (the lease component and maintenance) and the other nonlease component, which is the consumables. We will discuss this in further details in Separating Components - Lessors section below.

## 3.2 IDENTIFYING LEASE AND NONLEASE COMPONENTS

### 3.2.1 Identifying Components of the Contract

Components of a contract include only those items or activities that transfer a good or service to the lessee. Some other items or activities are not components.

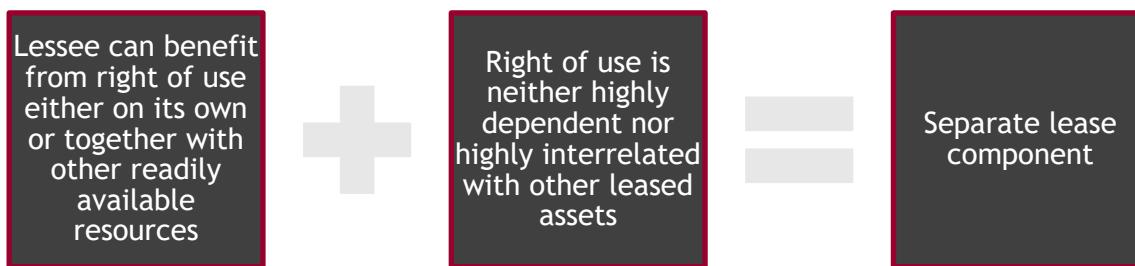
| LEASE COMPONENT EXAMPLES  | NONLEASE COMPONENT EXAMPLES   | NONCOMPONENT EXAMPLES   |
|---|---|---|
|  Right to use real estate, such as a retail store.<br> Right to use computer equipment.<br> Right to use a vehicle, such as a truck. |  Repairs and maintenance, common area maintenance.<br> Other goods or services provided to the lessee, such as security services, operating the asset (e.g., a vessel, a drilling rig), sale of consumables, etc. |  Certain administrative tasks to initiate the contract (e.g., set up activities).<br> Reimbursement of lessor costs related to ownership of the leased asset (such as property taxes and insurance that protects the lessor's asset). |

Lessees and lessors must identify the individual lease components and nonlease components of the contract, but do not have to separate the nonlease components from the associated lease component if a practical expedient to not separate is elected (see discussion below).

### 3.2.2 Lease Component Separation Guidance

#### 3.2.2.1 General Considerations

ASC 842 provides guidance in paragraph 842-10-15-28 on identifying separate lease components:



- ▶ In assessing the first condition, readily available resources are goods or services that are sold or leased separately (by the lessor or other suppliers) or resources that the lessee already has obtained (from the lessor or from other transactions or events). An entity may consider the following questions in determining whether this condition is met:
  - Is the asset readily sold or leased separately by the lessor or other suppliers?
  - Could the lessee readily lease or purchase an alternative asset to use with the other leased asset?

- In evaluating the second condition, a lessee's right to use an underlying asset is highly dependent on or highly interrelated with the right to use another underlying asset if each right of use significantly affects the other. An entity may consider the following questions in determining whether this condition is met:
- Can the lessor fulfill each of its obligations to lease one of the underlying assets independently of its fulfillment of the other lease obligations?
  - Would there be significant costs and time for the lessor to be able to fulfill its obligation on each leased asset?
  - Is the lessee's ability to derive benefits from the lease of each asset significantly affected by its decision to lease or not lease the other asset(s) from the lessor?

#### BDO INSIGHTS – LEASE COMPONENT SEPARATION GUIDANCE SIMILAR TO GUIDANCE IN ASC 606

The guidance in paragraph 842-10-15-28 on determining whether one or more lease components should be accounted for separately is similar to the guidance in paragraphs 606-10-25-19 through 25-21 on determining whether a good or service promised in a revenue contract is distinct, and therefore represents a separate performance obligation. This linkage was intentional as ASC 842 incorporates concepts from ASC 606, and therefore paragraph 842-10-15-28 should be applied in a manner similar to application of the guidance in ASC 606.

When applying paragraph 842-10-15-28, generally the right to use an underlying asset represents a separate lease component. For example, in a contract for the right to use two cars, each car represents a separate lease component, and the contract therefore includes two lease components. Also, while there are several potential underlying components that comprise each car, including the engine, seats, etc., the integral parts of the car do not meet the criteria for treatment as separate lease components. That is, the car is the lease component.

But in some cases, the right to use multiple underlying assets will represent a single lease component. Example 13 in ASC 842-10-55 illustrates a contract for the lease of a gas-fired turbine plant that consists of the turbine housed within a building together with the land on which the building sits. In that example, the rights to use the turbine, the building, and the land are highly interrelated because each is an input to the customized combined item for which the lessee contracted (i.e, the right to use a gas-fired turbine plant that can produce electricity for distribution to the lessee's customers). Accordingly, they represent a single lease component (absent additional considerations for land - see below). However, the fact that a lessee will use multiple underlying assets for one purpose is not sufficient to conclude that the rights of use are highly interrelated or interdependent of each other. The FASB illustrated this in Example 11 of ASC 842-10-55. We also illustrate it in the following examples.

**EXAMPLE 1 - LEASE OF HELICOPTER AND JET****FACTS**

- ▶ Lessee enters into a lease of a helicopter and a private jet from Lessor for two years for its key executives in the company for a specific project requiring significant travel.
- ▶ Lessor agrees to maintain the helicopter and the jet throughout the contract term.

**ANALYSIS**

- ▶ Lessee can benefit from each of the two assets on its own or together with other readily available resources. For example, Lessee could readily lease or purchase an alternative helicopter or jet to use with the other asset.
- ▶ Although Lessee is leasing the helicopter and jet for one purpose (key executives' travel related to a specific project), the helicopter and jet are not highly dependent nor highly interrelated with each other. The two assets are not, in effect, inputs to a combined item for which Lessee is contracting. Lessor can fulfill each of its obligations to lease one of the underlying assets independently of its fulfillment of the other lease obligation, and Lessee's ability to derive benefits from the lease of each asset is not significantly affected by its decision to lease or not lease the other equipment from Lessor.
- ▶ The maintenance services represent nonlease components because they provide Lessee with goods or services separate from the lease of the jet and helicopter. Also, Lessor determines under ASC 606 that its maintenance services for each piece of leased equipment are distinct and therefore are separate performance obligations.

**CONCLUSION**

There are two separate lease components and two separate nonlease components, unless the entity elects the practical expedient not to separate for this asset class, in which case:

- ▶ For Lessee, the contract has two separate lease components under ASC 842 (see Section 3.3 for additional details),
- ▶ For Lessor, the contract has either two separate lease components under ASC 842 or two separate performance obligations under ASC 606 depending on predominance (see Section 3.4 for additional details).

**EXAMPLE 2 - LEASE OF AIR PURIFICATION SYSTEM****FACTS**

- ▶ Clean Air Co. provides air purification systems, primarily to hospitals and other healthcare facilities, under leasing arrangements.
- ▶ Each system consists of multiple air filters and related equipment installed throughout the lessee's facility, in an amount and at locations determined based on the size and design of the facility.
- ▶ Lessee enters into a contract with Clean Air Co. for an air purification system that can filter the air at Lessee's healthcare facility and for maintenance of the system.
- ▶ Assume the contract contains a lease.

**ANALYSIS**

- ▶ Because of airflow throughout Lessee's facility, any individual air filter is ineffective on its own. Achieving air purification requires the full complement of air filters and related equipment provided in the arrangement.
- ▶ Therefore, the use of each air filter and related equipment used for the air purification system is highly dependent on the use of the other air filters and equipment. Each is an input to the customized combined item for which Lessee has contracted (that is, the right to use an air purification system that can filter the air at Lessee's healthcare facility).
- ▶ The maintenance services represent a nonlease component because they provide Lessee with goods or services separate from the lease. Also, Clean Air Co. determines under ASC 606 that its maintenance services represent a single performance obligation.

**CONCLUSION**

The contract contains one lease component (the right to use the air purification system) and one nonlease component (maintenance of the system), unless the entity elects the practical expedient not to separate for this asset class, in which case:

- ▶ For Lessee, the contract has one lease component under ASC 842 (see Section 3.3 for additional details).
- ▶ For Lessor, the contract has either one lease component under ASC 842 or one performance obligation under ASC 606 depending on predominance (see Section 3.4 for additional details).

**EXAMPLE 3 - LEASE OF LIGHT FIXTURES****FACTS**

- ▶ Lighting Co. provides energy-efficient light fixtures, primarily in industrial settings, under leasing arrangements. Payments under the leasing arrangements are based on calculated cost savings to lessees.
- ▶ Each arrangement consists of multiple light fixtures installed throughout the lessee's facility, in an amount and at locations determined based on the size and design of the facility.
- ▶ Lessee enters into a contract with Lighting Co. for energy-efficient light fixtures.
- ▶ Assume the contract meets the definition of a lease.

**ANALYSIS**

- ▶ Lessee can benefit from each of the light fixtures on its own or together with other readily available resources. For example, Lessee could readily lease or purchase alternative light fixtures.
- ▶ The purpose of the light fixtures is to provide a lower cost alternative to traditional lighting solutions. However, each light fixture provides a similar estimated cost saving and would provide the same level of cost savings regardless of whether each light fixture was installed on its own, or as part of a larger installation. Therefore, the right to use each light fixture is neither highly dependent on nor highly interrelated with the use of the other light fixtures.

**CONCLUSION**

- ▶ The contract contains multiple lease components; that is, each light fixture is a separate lease component.
- ▶ Lessee and Lighting Co cannot apply the practical expedient not to separate to this contract because there are no nonlease components in the contract. However, the entity may consider applying a portfolio approach (see Section 3.5).

### 3.2.2.2 Specific Considerations for Land

Irrespective of the guidance discussed above on separating lease components, ASC 842 requires a lease of land to be accounted for as a separate lease component unless the accounting effects of such separation would be insignificant. Paragraph 842-10-15-29 discusses two examples in which the accounting effect is insignificant:

- ▶ Separating the land component would not affect lease classification of any lease components,
- ▶ The amount recognized for the land lease component would be insignificant.

The Board noted in paragraph BC147 of ASU 2016-02 that “land, by virtue of its indefinite economic life and nondepreciable nature, is different from other assets, such that it should be assessed separately from other assets regardless of whether the separating lease components criteria are met.”

#### BDO INSIGHTS – IDENTIFYING LEASES OF LAND

Determining whether a contract includes a lease of land will depend on the facts and circumstances. In some cases, the analysis will be straightforward. For example, a contract for a lessee to lease an entire office building will include a lease of land on which the building sits, regardless of whether such lease of land is explicitly stated in the contract, because the lessee is leasing the entire building and therefore also exclusively benefits from the use of the land. In other cases, further analysis may be required. For example, in a contract for a lessee to lease retail space in a shopping mall, the analysis may depend on whether the lessee is the anchor tenant (and whether that anchor tenant occupies substantially all the shopping mall space), or another tenant that leases a smaller space (e.g., a lessee that leases a retail space on the second floor).

If it is determined that the contract includes a lease of land, the entity must account for the lease of land separately from the lease of the other assets unless doing so would be immaterial (e.g., lease classification would not change for either components, or the lease of land is immaterial).

**EXAMPLE 4 - LEASE OF LAND AND BUILDING****FACTS**

- ▶ Lessor and Lessee enter into a five-year lease of a single-story commercial office building.
- ▶ Lessee has exclusive use of the building (i.e., it is a single-tenant office building).
- ▶ The contract requires Lessee to pay Lessor for real estate taxes and insurance. Lessor is the primary obligor for the real estate taxes (regardless of whether Lessor leases the building and who the lessee is). Lessor is also the named insured on the insurance, which protects Lessor's investment in the building.
- ▶ The lease requires Lessor to perform landscaping services for Lessee.

**ANALYSIS**

- ▶ Regardless of whether the contract explicitly provides for the lease of land, the contract includes a lease of land because Lessee has exclusive use of the commercial office building, and therefore also exclusively benefits from use of the land on which the building sits.
- ▶ The lease of land and building are highly dependent on or highly interrelated with each other because each right of use significantly affects the other. However, because the contract contains a lease of land, Lessee and Lessor must consider the guidance in paragraph 842-10-15-29. Lessor and Lessee each conclude that the effect of accounting for the land lease component separately would be insignificant. In this contract, Lessee's right to use the land and building is coterminous and separating the two components would not change lease classification of either the land or building lease component.
- ▶ The real estate taxes and insurance on the building are not considered components of the contract because they are considered reimbursements of Lessor's costs for the land and building. See Section 3.3 for lessees and Section 3.4 for lessors for additional considerations on taxes and insurance.
- ▶ Finally, the landscaping services is a nonlease component because it transfers a good or service to Lessee separate from the lease of land and building. Lessor also determines under ASC 606 that the landscaping nonlease component represents a single performance obligation.

**CONCLUSION**

- ▶ The contract includes two components: a single lease component (comprising the right to use the land and building), and a nonlease component (landscaping services), unless the entity elects the practical expedient not to separate for this asset class.
- ▶ See Section 3.3 for additional guidance on accounting for the components and Example 4A for a continuation of this Example for Lessee.
- ▶ See Section 3.4 for additional guidance on accounting for the components and Example 4B for a continuation of this Example for Lessor.

**EXAMPLE 5 - LEASE OF OFFICE SPACE****FACTS**

- ▶ Lessor and Lessee enter into a five-year lease for one floor in a 30-story office building in New York City.
- ▶ Lessee has exclusive use of the floor.
- ▶ The lease requires Lessor to perform common area maintenance (CAM) services.
- ▶ The contract requires Lessee to reimburse Lessor for its pro-rata share of real estate taxes and insurance incurred by Lessor on the building, and CAM charges. The CAM charges can be adjusted upward and downward based on actual work performed by Lessor.

**ANALYSIS**

- ▶ The contract does not include a lease of land because Lessee does not occupy substantially all of the building (i.e., the land on which the building sits is shared by all of the tenants in the building).
- ▶ The real estate taxes and insurance Lessee will pay to Lessor are not considered components of the contract because they are considered reimbursements of Lessor's costs for the building. See Section 3.3 for lessees and Section 3.4 for lessors for additional considerations on taxes and insurance.
- ▶ The common area maintenance service is a nonlease component because it transfers a good or service to Lessee separate from the lease of the floor. Lessor also determines under ASC 606 that the common area maintenance represents a single performance obligation.

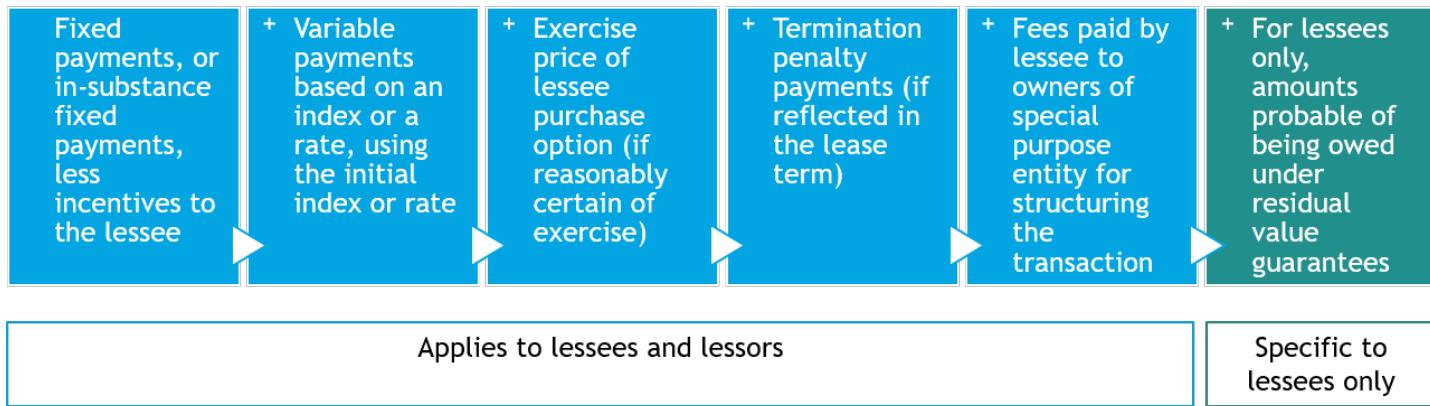
**CONCLUSION**

- ▶ The contract includes two components: one lease component and one nonlease component (common area maintenance services), unless the entity elects the practical expedient not to separate.
- ▶ See Section 3.3 for additional guidance on accounting for the components and Example 5A for a continuation of this Example for Lessee.
- ▶ See Section 3.4 for additional guidance on accounting for the components and Examples 5B and 5C for a continuation of this Example for Lessor.

### 3.3 SEPARATING COMPONENTS - LESSEES

#### 3.3.1 Determining the Consideration in the Contract

The consideration in the contract for a lessee is determined by applying paragraphs 842-10-15-35 and 842-10-30-5 and includes the following payments that will be made during the lease term:



For a lessee, the sum of the above payments represents the total consideration in the contract, which the lessee allocates to the separate lease and nonlease components of the contract, unless the lessee elects the practical expedient to not separate for this asset class (see discussion below).

Variable payments that depend on an index or a rate are initially measured using the index or rate at the commencement date. Subsequent changes to the index or rate during the lease term are accounted for as variable payments, unless the lessee is required to remeasure the lease for other reasons (see Chapter 5 for further details).

Variable payments that do not depend on an index or a rate are not included in the determination of the total consideration in the contract. This includes variable payments based on the performance of the asset, such as payments based on a percentage of sales of the lessee, or reimbursement of actual costs incurred by the lessor (such as property taxes and insurance).

Chapter 4 discusses in further details in-substance fixed payments, lease incentives, purchase options and termination options.

### 3.3.1.1 Property Taxes and Insurance

A lessee's requirement to pay costs that the lessor may incur in its role as a lessor or as owner of the underlying asset do not transfer a good or service to the lessee separate from the lease. Example 12, Case A of ASC 842-10-55 provides an example of a real estate lease and explains that:

- ▶ The property taxes on the building would be owed by the lessor regardless of whether it leased the building and who the lessee is; and
- ▶ For the insurance, the lessor is the named insured on the building insurance policy and therefore the insurance protects the lessor's investment in the building.

Accordingly, the lessee paying those costs solely represents a reimbursement of the lessor's costs. The fact that the lessee pays a third-party, including the taxing authority, rather than reimbursing the lessor does not change this conclusion. Also, the classification of a lease (e.g., as operating versus finance lease for the lessee) does not affect the analysis of whether costs are considered lessor costs or lessee costs.

The accounting by a lessee for reimbursement of lessor costs depends on whether the payments are fixed or variable.

| PAYMENTS ARE FIXED  | PAYMENTS ARE VARIABLE   |
|---|---|
| Payments are included in the consideration in the contract, which is allocated to the lease and nonlease components in the contract on a relative standalone price basis, unless the lessee elects the practical expedient not to separate for the asset class. Those payment amounts (or a portion of those if there are nonlease components) will affect the measurement of the lease on balance sheet. | Payments do not represent variable payments based on an index or a rate and, therefore, are not included in the consideration in the contract. Once the variable payments are incurred, they will be allocated between the lease and nonlease components using the same allocation as at contract's inception, or most recent reallocation. |
| <b>Example:</b> Lessee is required to pay lessor a fixed amount per year for insurance coverage on the leased asset.  | <b>Example:</b> Lessee is required to reimburse lessor for actual property taxes due on the asset under lease. Property taxes do not represent an index or a rate, and therefore are considered variable payments.  |

In some cases, there may be additional complexity in differentiating between lessee costs and lessor costs, particularly for insurance contracts for which there may be elements benefitting the lessor (e.g., protecting the leased asset) and others benefitting the lessee (e.g., protecting the lessee's owned assets or other contingencies). In those situations, additional analysis may be required to determine the portion of the payments that represent lessor costs (i.e., portion of the premium that protects the lessor's asset). Amounts that are considered lessee costs (i.e., portion of the premium protecting the lessee's assets) do not affect the accounting for the lease.

### 3.3.1.2 Sales Taxes and Similar Taxes

When an entity enters into a lease, taxes may be assessed on the contract by a governmental authority. Those taxes may be both imposed on and concurrent with a specific lease revenue-producing transaction and collected by the lessor from a lessee. This includes for example sales, use, value added, and some excise taxes. Unlike lessors (see Section 3.4), lessees do not have a practical expedient to not assess such taxes. Accordingly, a lessee is required to analyze sales taxes and other similar taxes on a jurisdiction-by-jurisdiction basis to determine whether those taxes are the primary obligation of the lessor as owner of the underlying asset being leased (i.e., the tax is a lessor cost) or whether those taxes are collected by the lessor on behalf of third parties (i.e., the tax is a lessee cost).

- ▶ If a lessor cost, the tax is accounted for either as part of the consideration in the contract (if the payments are fixed) or as variable payments that do not depend on an index or a rate.
- ▶ If a lessee cost, the tax typically does not impact lease accounting for the contract.

Like property taxes and insurance discussed above, the fact that the lessee pays a third-party directly rather than reimbursing the lessor for the tax does not impact this conclusion.

### 3.3.2 Practical Expedient Not to Separate

A lessee may elect as an accounting policy election by asset class, to not separate nonlease components from lease components and instead, to account for each separate lease component and nonlease components associated with that lease component as a single lease component.

The FASB provided this practical expedient to reduce cost and complexity in applying ASC 842. However, the election of the practical expedient results in a larger right-of-use asset and lease liability on balance sheet, and it may also change classification from an operating to a finance lease (See Chapter 4). Accordingly, companies will need to consider the pros (e.g., simplicity) and cons (e.g., impact on accounting for the lease, including balance sheet) of electing the practical expedient for their asset classes.

#### BDO INSIGHTS – NONLEASE COMPONENTS “ASSOCIATED WITH” THE LEASE COMPONENT

ASC 842 does not define or provide guidance for determining whether a nonlease component is “associated with” the lease component. A literal read of the requirements for the practical expedient may suggest that all nonlease components, whether provided at a point in time or over time, that are associated with the lease component should be combined with that lease component when the lessee elects the practical expedient. However, we note that ASC 842 illustrates in Example 11 of ASC 842-10-55 the application of the practical expedient to a contract in which the nonlease component is maintenance services on construction vehicles. Paragraph BC 149 of ASU 2016-02 also notes that “[t]he Board also decided that lessees should account for lease and nonlease (*typically, service*) components separately (unless they elect the practical expedient) [*Emphasis added*].” Accordingly, we believe the practical expedient to not separate was primarily intended for services and other nonlease components transferred over time and that relate to the lease component (e.g., maintenance of a leased equipment, common area maintenance for a lease of office space). For nonlease components provided at a point in time such as inventory purchases, we believe a lessee will frequently conclude that the component is not associated with the lease component because the lessee usually will be able to redirect the inventory and use it with a different asset, or to resell it in the market.

### 3.3.3 Allocating the Consideration to Lease and Nonlease Components

#### 3.3.3.1 General Considerations

If a lessee does not elect the practical expedient not to separate for an asset class, once the consideration in the contract is determined and the components are identified, a lessee allocates the consideration to the lease and nonlease components on a relative standalone price basis, based on the observable standalone price of each component. A price is observable if it is the price at which either the lessor or similar suppliers sell similar lease or nonlease components on a standalone basis. If observable standalone prices are not readily available, a lessee must estimate standalone prices maximizing the use of observable information. A residual approach may be acceptable if the standalone price for a component is highly variable or uncertain.

Paragraph BC156 in ASU 2016-02 states in part that “the allocation guidance for lessees is similar to that for lessors and also is broadly consistent with that in previous GAAP.”

A lessee also allocates initial direct costs to the separate lease components on the same basis as the lease payments.

#### EXAMPLE 6 - LEASE OF A CAR

##### FACTS

- ▶ Lessee leases a car for its salesperson from Dealership for three years.
- ▶ Lessee has the right to drive the car for up to 15,000 miles per calendar year and to bring the car into the maintenance department of Dealership once per quarter for regularly scheduled maintenance as defined in the lease agreement.
- ▶ The contract provides for a fixed payment of \$415 per month.
- ▶ Lessee is required to maintain full coverage insurance on the car to protect Dealership’s asset. Lessee must contract directly with an insurance agency of its choice.
- ▶ Lessee is required to pay for any maintenance services required beyond regularly scheduled maintenance defined in the contract.
- ▶ At the end of the lease term, Lessee is required to make additional fixed payments on a per mile basis for any mileage greater than 45,000 miles.
- ▶ Assume there are no lease incentives or initial direct costs.

##### WHAT ARE THE COMPONENTS?

- ▶ The contract contains two components: a lease component (lease of the car) and a nonlease component (maintenance services). The insurance coverage is not a component. It does not transfer a good or service separate from the lease of the car (it represents a lessor cost of owning the asset).
- ▶ However, Lessee may elect to apply the practical expedient not to separate for this asset class, in which case the contract would contain a single lease component.

##### WHAT IS THE CONSIDERATION IN THE CONTRACT?

- ▶ The contract includes a fixed monthly payment of \$415, payments for insurance (paid by Lessee directly to the insurance company of its choice), payments for excess mileage at the end of the lease term, and payments for extra maintenance.
- ▶ Only the fixed monthly payment of \$415 is included in the consideration in the contract. The other payments are variable payments that do not depend on an index or a rate.
- ▶ The consideration in the contract is \$14,940 ( $\$415 \times 36$  months).

### WHAT ARE THE AMOUNTS ALLOCATED TO THE LEASE COMPONENT?

#### SCENARIO 1: Lessee elects practical expedient not to separate for this asset class.

- ▶ In that situation, the contract includes only one component (i.e., the lease component).
- ▶ The consideration in the contract of \$14,940 is allocated entirely to the lease component and is used to account for the lease (e.g., assess lease classification, recognize the lease on balance sheet, etc.).
- ▶ All variable payments (for insurance, excess mileage and extra maintenance, if any) are considered variable lease payments, which will be recognized in the period in which the obligation for those payments is incurred. Lessee will also consider the guidance in paragraph 842-20-55-1 for variable payments based on the attainment of 45,000 miles.

#### SCENARIO 2: Lessee does not elect practical expedient not to separate for this asset class.

- ▶ In that case, Lessee allocates the consideration in the contract to the lease and maintenance components on a relative standalone price basis. Lessee identifies observable standalone prices for the vehicle lease and maintenance services. Lessee determines that it could enter into a maintenance agreement with an unrelated service center for \$30 per month, and Dealership commonly leases the same car on a standalone basis for \$400 per month. Therefore, the consideration in the contract is allocated to the lease and non-lease components as follows:

|             | Standalone Price   | Relative<br>Standalone Price |
|-------------|--------------------|------------------------------|
| Car lease   | \$ 14,400          | \$ 13,898 (93.02%)           |
| Maintenance | 1,080              | 1,042 ( 6.98%)               |
|             | <hr/><br>\$ 15,480 | <hr/><br>\$ 14,940           |

- ▶ The amount of the consideration allocated to the lease component (\$13,898) is used to account for the lease component (e.g., assess lease classification, recognize the lease on balance sheet, etc.).
- ▶ The amount of consideration for the maintenance component (\$1,042) is accounted for under other GAAP.
- ▶ All variable payments for insurance, excess mileage and extra maintenance will be allocated when incurred using the same allocation basis as for the consideration in the contract (i.e., on a 93.02%/6.98% basis).

### EXAMPLE 4A - LEASE OF LAND AND BUILDING (CONTINUED) - LESSEE ACCOUNTING

#### FACTS

- ▶ Let's continue with Example 4 in which Lessor and Lessee enter into a five-year lease of a single-story commercial office building.
- ▶ Lessee has exclusive use of the building (i.e., it is a single-tenant office building).
- ▶ The lease requires Lessor to perform landscaping services for Lessee.
- ▶ Lessee pays a fixed monthly payment of \$12,000 per month in arrears which includes rent, landscaping services, and reimbursement of Lessor's costs.
- ▶ Assume there are no lease incentives or initial direct costs.

#### WHAT ARE THE COMPONENTS?

- ▶ As previously evaluated, the contract includes two components: a single lease component (comprising the right to use the land and building), and a nonlease component (landscaping services).
- ▶ However, Lessee may elect to apply the practical expedient not to separate for this asset class, in which case the contract would contain a single lease component.

#### WHAT IS THE CONSIDERATION IN THE CONTRACT?

- ▶ The consideration in the contract is \$12,000 X 12 months X 5years = \$720,000

#### WHAT ARE THE AMOUNTS ALLOCATED TO THE LEASE COMPONENT?

##### SCENARIO 1: Lessee elects practical expedient not to separate for this asset class.

- ▶ In that situation, the contract includes a single lease component.
- ▶ The consideration in the contract of \$720,000 is allocated entirely to the lease component and is used to account for the lease (e.g., assess lease classification, recognize the lease on balance sheet, etc.).

##### SCENARIO 2: Lessee does not elect practical expedient not to separate for this asset class.

- ▶ In that case, Lessee allocates the consideration in the contract to the lease component and landscaping services component on a relative standalone price basis. Lessee determines the standalone prices for the lease component and nonlease component are \$680,000 and \$50,000, respectively. Therefore, the consideration in the contract is allocated to the lease and non-lease components as follows:

|                       | Standalone Price        | Relative<br>Standalone Price |
|-----------------------|-------------------------|------------------------------|
| Lease component       | \$ 680,000              | \$ 670,685 (93.15%)          |
| Maintenance component | \$ 50,000               | \$ 49,315 ( 6.85%)           |
|                       | <hr/> <b>\$ 730,000</b> | <hr/> <b>\$ 720,000</b>      |

- ▶ The amount of the consideration in the contract allocated to the lease component (\$670,685) is used to account for the lease component (e.g., assess lease classification, recognize the lease on balance sheet, etc.). The amount of consideration for the maintenance component (\$49,315) is accounted for under other GAAP.

**EXAMPLE 5A - LEASE OF OFFICE SPACE (CONTINUED) - LESSEE ACCOUNTING****FACTS**

- ▶ Let's continue Example 5 in which Lessor and Lessee enter into a five-year lease for one floor in a 30-story office building in New York City.
- ▶ The lease requires Lessor to perform common area maintenance (CAM) services.
- ▶ The contract requires Lessee to pay rent of \$50,000 per month in arrears and to reimburse Lessor for Lessee's pro-rata share of real estate taxes and insurance incurred by Lessor on the building, and CAM charges.
- ▶ The pro rata share of those reimbursements is initially estimated at \$9,000 per month (\$5,000 for taxes and insurance and \$4,000 for CAM). The CAM charges can be adjusted upward and downward based on actual work performed by Lessor.
- ▶ Assume there are no lease incentives or initial direct costs.

**WHAT ARE THE COMPONENTS?**

- ▶ As previously evaluated, the contract includes two components: one lease component (lease of the floor) and one nonlease component (CAM services).
- ▶ However, Lessee may elect to apply the practical expedient not to separate for this asset class, in which case the contract would contain a single lease component.

**WHAT IS THE CONSIDERATION IN THE CONTRACT?**

- ▶ The consideration in the contract is  $\$50,000 \times 12 \text{ months} \times 5 \text{ years} = \$3,000,000$ .
- ▶ The other payments Lessee will make to Lessor for its prorata share of real estate taxes, insurance and CAM are variable payments that do not depend on an index or a rate. Therefore, they are not included in the consideration in the contract.

**WHAT ARE THE AMOUNTS ALLOCATED TO THE LEASE COMPONENT?****SCENARIO 1: Lessee elects practical expedient not to separate for this asset class.**

- ▶ In that situation, the contract includes only one component (i.e., the lease component).
- ▶ The consideration in the contract of \$3,000,000 is allocated entirely to the lease component and is used to account for the lease (e.g., assess lease classification, recognize the lease on balance sheet, etc.).
- ▶ Lessee's payments for its prorata share of property taxes, insurance and CAM are variable lease payments that do not depend on an index or a rate and are excluded from the measurement of the lease liability. Those variable lease payments are recognized in profit or loss when incurred.

**SCENARIO 2: Lessee does not elect practical expedient not to separate for this asset class.**

- In that case, Lessee allocates the consideration in the contract to the lease and CAM components on a relative standalone price basis. Lessee determines the standalone prices for the lease component and CAM component are \$3,270,000 and \$270,000, respectively. Therefore, the consideration in the contract is allocated to the lease and non-lease components as follows:

|                              | Standalone Price          | Relative<br>Standalone Price |
|------------------------------|---------------------------|------------------------------|
| Lease component              | \$ 3,270,000              | \$ 2,771,186 (92.37%)        |
| CAM component <sup>(1)</sup> | 270,000                   | 228,814 ( 7.63%)             |
|                              | <hr/> <b>\$ 3,540,000</b> | <hr/> <b>\$ 3,000,000</b>    |

(1) Includes an appropriate profit margin

- The amount of the consideration allocated to the lease component (\$2,771,186) is used to account for the lease component (e.g., assess lease classification, recognize the lease on balance sheet, etc.).
- The amount of consideration allocated to CAM services (\$228,814) is accounted for under other GAAP.
- All variable payments for Lessee's prorata share of real estate taxes, insurance, and CAM are allocated using the same allocation basis as for the consideration in the contract (i.e., on a 92.37%/7.63% basis).

In the prior example, it is important to note that if the practical expedient not to separate is not elected, the variable payments must be allocated between the lease and nonlease components despite the fact that the lease clearly provides for specific charges related to the nonlease services, i.e. CAM. This is because a lessee is not allowed to allocate variable consideration solely to the nonlease component, as lessors are allowed to.

### 3.3.3.2 Applying the Residual Approach

In accordance with paragraph 842-10-15-33, if a lessee has elected to separate lease and non-lease components, then it must allocate the consideration in the contract between the lease component(s) and the non-lease component(s) on a relative standalone price basis. The guidance further states that "if observable standalone prices are not readily available, the lessee shall estimate the standalone prices, maximizing the use of observable information." The guidance also indicates that "a residual estimation approach may be appropriate if the standalone price for a component is highly variable or uncertain."

Paragraph BC156 of ASU 2016-02 states in part that "the allocation guidance for lessees is similar to that for lessors and also is broadly consistent with that in previous GAAP." Lessors apply the allocation requirements in ASC 606, including paragraph 606-10-32-34, which provides the guidance on the suitable methods for estimating the standalone selling prices (including a residual approach). In accordance with paragraph 606-10-32-34(c), under the residual approach an "entity may estimate the standalone selling price by reference to the total transaction price less the sum of the *observable* standalone selling prices of other goods or services promised in the contract. [Emphasis added]" However, the following criteria must also be met in order to use the residual approach:

- The entity sells the same good or service to different customers (at or near the same time) for a broad range of amounts (that is, the selling price is highly variable because a representative standalone selling price is not discernible from past transactions or other observable evidence); or
- The entity has not yet established a price for that good or service and the good or service has not previously been sold on a standalone basis (that is, the selling price is uncertain).

As suggested by the guidance above, a lessee must have observable standalone prices for at least some of the components in the contract to apply the residual approach. In other words, if the lessee does not have observable standalone prices for any of the components, it must estimate the standalone price for all components. That is, the lessee cannot use the residual approach.

In addition, in order for a lessee to meet the additional criteria and thus use the residual approach in a lease, the entity i) would need to lease similar assets (for example, similar asset types and in a similar location) for a very broad

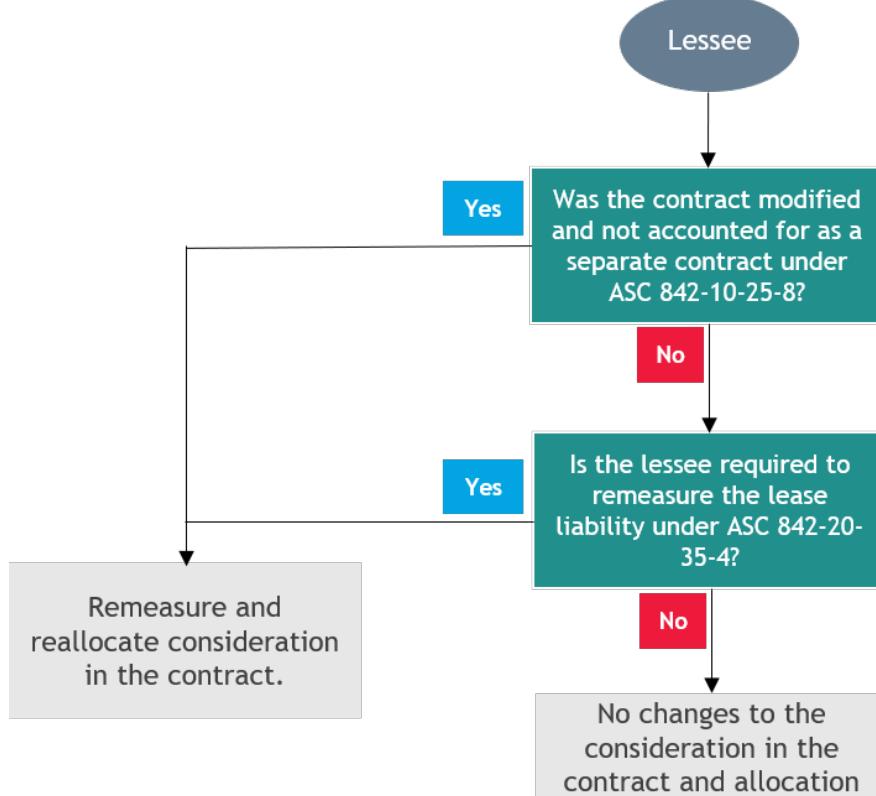
range of amounts indicating a representative standalone price is not discernible from past transactions or ii) has not previously leased the applicable type of assets and is unable to determine a standalone price because there are no similar transactions that the entity can use as a benchmark. It should be noted that the criteria in paragraph 606-10-32-34(c) are deliberately very restrictive. Consequently, although a lessee could use the residual method if the criteria are met, it is considered very unlikely that this will occur frequently in practice.

### 3.3.4 Remeasuring and Reallocating the Consideration

Inevitably, modifications to contracts and changes in facts and circumstances may occur during the contract term. Paragraph 842-10-15-36 requires a lessee to remeasure the consideration in the contract and to reallocate the consideration to the components in the contract when certain events occur. Those are:

- ▶ The effective date of a contract modification that is not accounted for as a separate contract per paragraph 842-10-25-8, and
- ▶ Remeasurements of the lease liability, such as a remeasurement resulting from a change in the lease term or change in assessment of a lessee purchase option, per paragraph 842-20-35-4.

Events that require remeasurement will be discussed in further detail in Chapter 5 on lessee accounting.



However, a lessee's requirement to reallocate the consideration in the contract would depend on whether it elected the practical expedient not to separate for the relevant asset class.

## 3.4 SEPARATING COMPONENTS - LESSORS

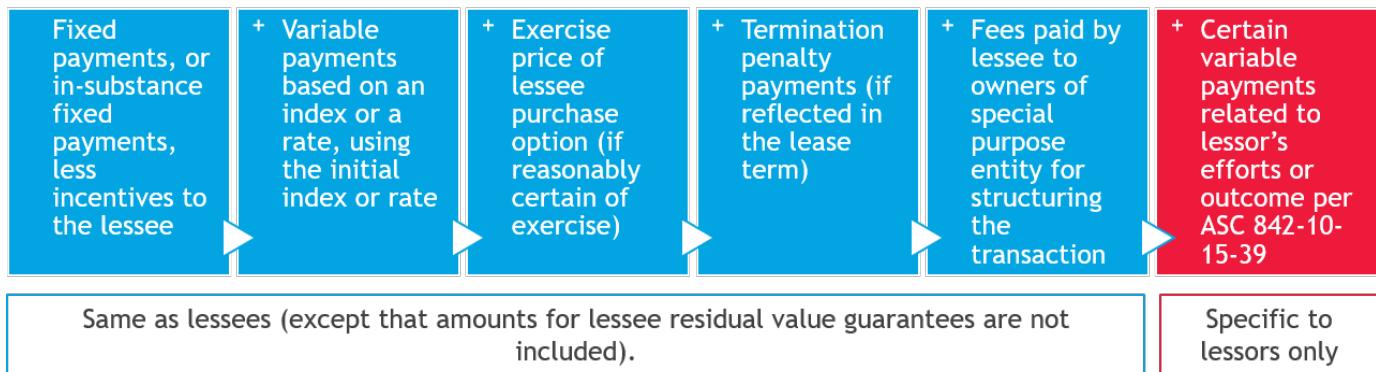
### 3.4.1 Determining the Consideration in the Contract

The consideration in the contract for a lessor includes *as a starting point* the payments described in paragraphs 842-10-15-35 and 842-10-30-5 (that is, the same payment amounts as those determined by the lessee, except that a lessor does not include amounts probable of being owed under a lessee residual value guarantee).

The consideration also includes certain variable payments related to the lessor's efforts in transferring (or an outcome in transferring) one or more goods or services that are not leases, consistent with the guidance in ASC 606.

There are also additional considerations for sales taxes and similar taxes, and reimbursements of lessor costs which we will discuss separately.

The following graph summarizes a lessor's consideration in the contract.



#### 3.4.1.1 Variable Payments Related to Lessor's Efforts or Outcome

The consideration for a lessor includes variable payment amounts that would be included in the transaction price in accordance with the guidance on variable consideration in ASC 606 when they relate specifically to:

- ▶ the lessor's efforts to transfer one or more goods or services that are not leases, or
- ▶ an outcome from transferring one or more goods or services that are not leases.

Those amounts are included in the consideration in the contract if it is probable that a significant revenue reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved (consistent with the constraint on variable consideration in ASC 606).

However, if the terms of a variable payment amount (other than those that depend on an index or a rate) relate to a lease component, **even partially**, the lessor does not include those payments in the consideration in the contract.

Example 14 in ASC 842-10-55 illustrates this guidance to a contract for the lease of equipment that includes maintenance for which consideration is a fixed amount plus a variable payment amount based on a minimum number of hours that the asset operates at a specified level of productivity. In Cases B and C of that example, the variable payment amounts for maintenance are included in the consideration in the contract because the maintenance services on the equipment are highly specialized and no entity would expect the equipment to meet the performance metrics without the specialized maintenance services.

In real estate scenarios, examples of variable payments that would not be included in the consideration in the contract include variable payments of the lessor's property taxes and insurance, or payments based on sales of the lessee. This is because those payment amounts relate at least partially to the lease component. Examples of variable payments that would be included in the consideration in the contract include payments for common area maintenance (CAM) services if such payments relate solely to the lessor's efforts to provide the CAM services.

However, even if variable payments relate specifically to the nonlease component(s), when a lessor elects the practical expedient not to separate for the asset class (assuming the nonlease component qualifies for combination with the lease component and the lease component is the predominant component), the variable payments are not

included in the consideration in the contract. This is because the lessor elected the practical expedient and the variable payments now relate to the lease component. See further discussion below on the lessor practical expedient.

#### BDO INSIGHTS – ASSESSMENT ON VARIABLE PAYMENTS BY LESSOR IN ACCORDANCE WITH ASC 606

The treatment of variable payments other than those based on an index or a rate is one major difference in the determination of the consideration in the contract between lessees and lessors. Determining whether certain variable payments relate solely to a nonlease component may require significant judgment, as may estimating the consideration, subject to the constraint in accordance with ASC 606. Lessors that engage in transactions with significant variable payments may consider developing a policy to assess in a consistent manner the nature of variable payments including earning mechanisms and triggering points for payment to assess whether such payments are solely related to a nonlease component in accordance with paragraph 842-10-15-39.

#### 3.4.1.2 Reimbursement of Lessor Costs

As previously explained, lessor costs such as property taxes on the underlying asset and insurance that protects the lessor's asset, are not considered a component of the contract. Absent guidance to the contrary, a lessor would be required to report such lessor costs on a gross basis (i.e., as revenue and expenses) whether the lessee reimburses the lessor or pays such costs on lessor's behalf to a third-party. However, when the lessee pays a third-party directly, lessors noted that reporting those costs in profit or loss would be costly and complex because the lessor may not have visibility into the actual amounts paid by the lessee and therefore may need to estimate those amounts. Lessors also questioned the usefulness of amounts reported because those often would be based on estimates that are affected by lessee-specific factors (for example, insurance premiums paid by the lessee for a policy that protects both the lessor's asset and other assets that the lessee owns, amount of deductible selected by the lessee, etc.).

Accordingly, notwithstanding the guidance on variable payments discussed previously, the accounting for lessor costs is as follows:

| LESSEE PAYS LESSOR COSTS DIRECTLY TO A THIRD-PARTY   | LESSOR PAYS COSTS AND IS REIMBURSED BY LESSEE  |
|--|--|
| <ul style="list-style-type: none"> <li>▶ Exclude from variable payments.</li> <li>▶ In other words, treat like a lessee cost, which does not affect the accounting for the lease.</li> </ul> | <ul style="list-style-type: none"> <li>▶ Account for costs excluded from the consideration in the contract as lessor costs (i.e., as variable payments).</li> <li>▶ In other words, recognize on a gross basis.</li> </ul> |

#### 3.4.1.3 Sales Taxes and Similar Taxes

A lessor can make an accounting policy election to exclude from the consideration in the contract and from variable payments not included in the consideration all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific lease revenue-producing transaction and collected by the lessor from a lessee. This includes for example sales, use, value added, and some excise taxes. Absent that practical expedient, the analysis of sales taxes and similar taxes could be costly and complex depending on the number of jurisdictions and the variation of, and changes in, tax laws among those jurisdictions.

This practical expedient is consistent with the practical expedient provided in ASC 606 and reduces costs and complexity in assessing sales taxes and similar taxes. When the lessor makes the election, it should comply with the disclosure requirements in paragraph 842-30-50-14.

However, taxes assessed on a lessor's total gross receipts or on the lessor as owner of the underlying asset (e.g., property taxes - see discussion above) are excluded from the scope of this election.

### 3.4.2 Practical Expedient Not to Separate

In July 2018, the FASB issued ASU 2018-11, which provides lessors with a practical expedient similar to lessees to not separate lease and nonlease components by asset class, if certain criteria are met.

As provided by paragraph 842-10-15-42A, a lessor may, as an accounting policy election by asset class, choose to not separate nonlease components from lease components and, instead, to account for each separate lease component and the nonlease components associated with that lease component as a single lease component if the following three conditions are met:

- ▶ The nonlease component(s) otherwise would be accounted for under ASC 606,
- ▶ The timing and pattern of transfer of the lease component and nonlease component(s) associated with that lease component are the same, and
- ▶ The lease component, if accounted for separately, would be classified as an operating lease.

Also, in accordance with paragraph 842-10-15-42B, for arrangements that qualify for the scope of this practical expedient, the way in which a lessor accounts for the combined component depends on predominance:

| NONLEASE COMPONENT(S) IS (ARE) PREDOMINANT   | LEASE COMPONENT IS PREDOMINANT   |
|--|--|
| <ul style="list-style-type: none"> <li>▶ Account for combined component as a single performance obligation under ASC 606.</li> </ul>   | <ul style="list-style-type: none"> <li>▶ Account for the combined component as a single lease component under ASC 842.</li> </ul>  |
| <ul style="list-style-type: none"> <li>▶ Use same measure of progress used in determining whether the arrangement qualified for the expedient (i.e., the lessor uses a straight-line measure of progress).</li> </ul>                          | <ul style="list-style-type: none"> <li>▶ Account for the lease as an operating lease.</li> </ul>   |
| <ul style="list-style-type: none"> <li>▶ Account for all variable payments related to any good or service, <i>including the lease</i>, that is part of the combined component under the variable consideration guidance in ASC 606.</li> </ul> | <ul style="list-style-type: none"> <li>▶ Account for all variable payments related to any good or service that is part of the combined component as variable <i>lease</i> payments.</li> </ul> |

In assessing predominance, a lessor should evaluate whether the lessee would be reasonably expected to ascribe more value to the nonlease component(s) than to the lease component.

Also, when a contract includes a lease component and multiple nonlease components, some of the nonlease components may meet the conditions to be combined with the lease component, while other nonlease components may not (for example, a nonlease component that transfers at a point in time). In this case, this does not preclude the lessor from applying the practical expedient to the contract. However, the lessor is required to separate and allocate the consideration in the contract between the combined component on one hand (i.e., the lease component and nonlease components that meet the conditions) and the nonlease components (those that do not qualify) on the other hand.

**BDO INSIGHTS – APPLICATION CONSIDERATIONS FOR LESSOR PRACTICAL EXPEDIENT NOT TO SEPARATE**

The following considerations are important in understanding and evaluating whether a lessor qualifies for the practical expedient:

- ▶ The practical expedient applies only to nonlease components that otherwise would be accounted for under ASC 606. It does not apply, for example, to a contract that includes a lease component and a loan component accounted for under ASC 310 on receivables.
- ▶ Determining whether the lease component would be classified as an operating lease if accounted for separately generally should not require a detailed quantitative analysis and may often be determined using either a reasonable qualitative assessment, or a simplified quantitative approach in which all payments in the contract are used to perform the present value classification test (to test if the lease would be classified as an operating lease even with all payments) in addition to assessing the other lease classification tests. However, in certain situations, additional analysis may be required.
- ▶ Because the timing and pattern of transfer of the nonlease components must be the same as the timing and pattern of transfer of the lease, the nonlease components will generally need to be recognized on a straight-line basis (i.e., over time, time-based) to qualify for the practical expedient (see Note 1 below). Performance obligations satisfied over time but using a measure of progress different from a time-elapsed measure of progress, or performance obligations satisfied at a point in time (even if satisfied ratably throughout the lease term), do not qualify for the practical expedient (See Note 2).
- ▶ A lessor should be able to reasonably determine which component is predominant (i.e., a lessor does not have to perform a detailed quantitative analysis or theoretical allocation). We also believe entities may use a >50% threshold in determining which component is predominant for this lessor practical expedient as discussed by the FASB in a public Board meeting.

We believe many lessor entities (including real estate entities and cable providers, to name a few) will take advantage of this lessor practical expedient, as it generally may enable them to account for their transactions under ASC 842 or ASC 606 in a manner similar to how they have accounted for them in the past, and how users of their financial statements have used the information.

**Note 1:** Paragraph 842-30-25-11(a) requires a lessor to recognize operating lease payments on a straight-line basis unless another systematic and rational basis is more representative of the pattern in which the lessee benefits from use of the underlying asset. However, in practice, it generally is infrequent for anything other than straight-line recognition to be applied.

**Note 2:** It is important to note that while the pattern of transfer of the nonlease components must be the same as the lease component, the recognition of revenue does not have to be the same. For example, if the contract includes variable consideration, the recognition pattern under ASC 606 for the nonlease component may not be the same as the pattern of recognition under ASC 842. The fact that the two different standards provide for differences in the recognition of variable consideration would not preclude a lessor from electing the practical expedient if the timing and pattern of transfer of the lease and nonlease components are the same.

**BDO INSIGHTS – APPLYING LESSOR PRACTICAL EXPEDIENT MAY CHANGE AMOUNT OF CONSIDERATION IN THE CONTRACT**

A key consequence of the lessor practical expedient not to separate is that it may change the consideration in the contract for a lessor when the contract includes variable payments. For example, a real estate contract may provide for the right to use an office building along with common area maintenance (CAM) services. The contract may stipulate that the lessee will pay a fixed payment amount per month and will reimburse the lessor for property taxes, insurance, and CAM costs incurred by the lessor. Absent the lessor applying the practical expedient for this asset class, the lessee's reimbursements for CAM services would meet the conditions in paragraph 842-10-15-39 to be included in the consideration in the contract because the payments relate specifically to the lessor's efforts in transferring a good or service to the lessee that is not the lease. However, when the lessor has elected and applies the practical expedient for this asset class, the contract includes only one lease component (assuming there are no other nonlease components in the contract that do not qualify for the practical expedient). Accordingly, variable payments the lessee will make to the lessor under the contract are all considered to relate to the lease component (even the payments for CAM services), and therefore no variable payment amounts will be included in the consideration in the contract. We illustrate this in Examples 5B and 5C below.

### 3.4.3 Allocating the Consideration to Lease and Nonlease Components

If a lessor does not elect the practical expedient not to separate, or elects it but the criteria for combination are not met for one or more nonlease components, the lessor allocates the consideration in the contract using the revenue guidance in paragraphs 606-10-32-28 through 32-41.

Also, as previously discussed, lessors should include in the consideration in the contract (subject to the constraint) variable payments that relate specifically to:

- ▶ The lessor's efforts to transfer one or more goods or services that are not leases, or
- ▶ An outcome from transferring one or more goods or services that are not leases.

If included in the consideration, those variable payment amounts are allocated entirely to the nonlease component(s) to which the variable payment specifically relates if doing so would be consistent with the transaction price allocation objective in paragraph 606-10-32-28.

However, if the terms of the variable payment amount (other than those that depend on an index or a rate) relate to a lease component, *even partially*, the lessor cannot recognize those payments before the changes in facts and circumstances on which the variable payment is based occur (for example, when the lessee's sales on which the amount of the variable payment depends occur). When the changes in facts and circumstances on which the variable payment is based occur, the lessor should allocate those payments to the lease and nonlease components of the contract. In doing so, the allocation should be on the same basis as the initial allocation of the consideration in the contract, or the most recent modification not accounted for as a separate contract, unless the variable payment meets the criteria in paragraph 606-10-32-40 to be allocated only to the lease component(s). After this allocation then:

- ▶ Variable payment amounts allocated to the lease component(s) are recognized as income in profit or loss in accordance with ASC 842,
- ▶ Variable payment amounts allocated to nonlease component(s) are recognized in accordance with other Topics such as ASC 606.

A lessor also allocates any capitalized costs (for example, initial direct costs or contract costs capitalized under ASC 340-40 on other assets and deferred costs) to the separate lease components or nonlease components to which those costs relate.

**EXAMPLE 4B - LEASE OF LAND AND BUILDING (CONTINUED) - LESSOR ACCOUNTING****FACTS**

- ▶ Let's continue with Example 4 in which Lessor and Lessee enter into a five-year lease of a single-story commercial office building.
- ▶ Lessee has exclusive use of the building (i.e., it is a single-tenant office building).
- ▶ The lease requires Lessor to perform landscaping services for Lessee.
- ▶ Lessee pays a fixed monthly payment of \$12,000 per month in arrears which includes rent, landscaping services, and reimbursement of Lessor's costs.
- ▶ Assume there are no lease incentives or initial direct costs.

**WHAT ARE THE COMPONENTS?**SCENARIO 1: Lessor elects practical expedient not to separate for this asset class.

- ▶ Lessor determines that it meets the scope conditions of the practical expedient under paragraph 842-10-15-42A because:
  - The landscaping services would otherwise be accounted for under ASC 606.
  - The lease component would be accounted for as an operating lease. Lessor performed this assessment qualitatively considering the terms of the contract (see Chapter 4 for additional guidance on lease classification).
  - The lease component and nonlease component have the same timing and pattern of transfer (i.e., overtime, time-based). Lessor determined that the pattern of transfer of the landscaping services would be time-based and over time under ASC 606 based on the nature of the performance obligation.
- ▶ Lessor also determines that the nonlease component is not the predominant component, because Lessee would be reasonably expected to ascribe more value to the lease component than the nonlease component.
- ▶ Lessor notes that paragraph 842-10-15-42C is not applicable because there is only one nonlease component and it qualifies for the practical expedient not to separate.
- ▶ Accordingly, the contract includes one lease component (i.e., the combined components), which Lessor accounts for as an operating lease under ASC 842 consistent with paragraph 842-10-15-42B.

SCENARIO 2: Lessor does not elect practical expedient not to separate for this asset class.

- ▶ As previously evaluated in Example 4, the contract includes two components: a single lease component (comprising the right to use the land and building), and a nonlease component (landscaping services).
- ▶ Also, Lessor determines under ASC 606 that its landscaping services represent a single performance obligation.

**WHAT IS THE CONSIDERATION IN THE CONTRACT?**

- ▶ There are no variable payments in the contract. Therefore, the guidance in paragraph 842-10-15-39 does not apply.
- ▶ The consideration in the contract for Lessor is \$12,000 X 12 months X 5 years = \$720,000.

## WHAT ARE THE AMOUNTS ALLOCATED TO THE LEASE COMPONENT?

### SCENARIO 1: Lessor elects practical expedient not to separate for this asset class.

- ▶ The consideration in the contract of \$720,000 is allocated entirely to the lease component.
- ▶ Lessor accounts for the lease component as an operating lease in accordance with paragraph 842-10-15-42B, and therefore recognizes \$720,000 on a straight-line basis over the lease term.

### SCENARIO 2: Lessor does not elect practical expedient not to separate for this asset class.

- ▶ In that case, Lessor allocates the consideration in the contract to the lease and nonlease components on a relative standalone selling price basis. Lessor determines that the standalone selling prices for the lease component and nonlease component are \$680,000 and \$50,000, respectively, using the guidance in ASC 606.
- ▶ Therefore, the consideration in the contract is allocated to the lease and non-lease components as follows:

|                       | Standalone<br>Selling Price | Relative Standalone<br>Selling Price |
|-----------------------|-----------------------------|--------------------------------------|
| Lease component       | \$ 680,000                  | \$ 670,685 (93.15%)                  |
| Maintenance component | <u>50,000</u>               | <u>49,315 ( 6.85%)</u>               |
|                       | <u>\$ 730,000</u>           | <u>\$ 720,000</u>                    |

- ▶ The amount of the consideration in the contract allocated to the lease component (\$670,685) is used to account for the lease component (e.g., assess lease classification, recognize lease revenue, etc.).
- ▶ The amount of consideration for the landscaping component (\$49,315) is accounted for under ASC 606.

**EXAMPLE 5B - LEASE OF OFFICE SPACE (*CONTINUED*) - LESSOR ACCOUNTING, PRACTICAL EXPEDIENT NOT TO SEPARATE IS ELECTED****FACTS**

- ▶ Let's continue Example 5 in which Lessor and Lessee enter into a five-year lease for one floor in a 30-story office building in New York City.
- ▶ The lease requires Lessor to perform common area maintenance (CAM) services.
- ▶ The contract requires Lessee to pay rent of \$50,000 per month in arrears and to reimburse Lessor for Lessee's pro-rata share of real estate taxes and insurance incurred by Lessor on the building, and CAM charges.
- ▶ The pro rata share of those reimbursements is initially estimated at \$9,000 per month (\$5,000 for taxes and insurance and \$4,000 for CAM). The CAM charges can be adjusted upward and downward based on actual work performed by Lessor.
- ▶ Assume there are no lease incentives or initial direct costs.
- ▶ Lessor elects the practical expedient not to separate for this asset class.

**WHAT ARE THE COMPONENTS?**

- ▶ Lessor determines that it meets the scope conditions of the practical expedient in paragraph 842-10-42A because:
  - The CAM services would otherwise be accounted for under ASC 606.
  - The lease component would be accounted for as an operating lease. Lessor performed this assessment qualitatively considering the terms of the contract (see Chapter 4 for additional guidance on lease classification).
  - The lease component and nonlease component have the same timing and pattern of transfer (i.e., over time, time-based). Lessor determined that the pattern of transfer of CAM would be time-based and over time under ASC 606 based on the nature of the performance obligation.
- ▶ Lessor also determines that the nonlease component is not the predominant component, because Lessee would be reasonably expected to ascribe more value to the lease component than the nonlease component.
- ▶ Lessor notes that paragraph 842-10-15-42C is not applicable because there is only one nonlease component and it qualifies for the practical expedient not to separate.
- ▶ Accordingly, the contract includes one lease component (i.e., the combined components).

**WHAT IS THE CONSIDERATION IN THE CONTRACT?**

- ▶ The consideration in the contract starts with the same amount as determined by Lessee, which is \$50,000 X 12 months X 5years = \$3,000,000
- ▶ There are variable payments in the contract. Therefore, Lessor applies the guidance in paragraph 842-10-15-39. However, Lessor determines that the payments Lessee will make to Lessor for its prorata share of real estate taxes and insurance are variable payments that are not based on an index or a rate, and they relate to the lease component.
- ▶ Also, although the CAM payments relate specifically to the CAM services, Lessor elected the practical expedient and therefore those payments are considered to relate to the lease component.
- ▶ Accordingly, the expected amounts for property taxes, insurance and CAM are excluded from the consideration in the contract in accordance with paragraph 842-10-15-40.
- ▶ The consideration in the contract for Lessor is \$3,000,000.

**WHAT ARE THE AMOUNTS ALLOCATED TO THE LEASE COMPONENT?**

- ▶ The lease is accounted for as an operating lease consistent with paragraph 842-10-15-42B.
- ▶ The consideration in the contract of \$3,000,000 is allocated entirely to the lease component and is used to recognize lease revenue on a straight-line basis over the lease term.
- ▶ Because Lessee reimburses Lessor for property taxes and insurance (as opposed to paying directly a third-party), Lessee's payments for its prorata share of those activities are considered lessor costs in accordance with paragraph 842-10-15-40A and are recognized on a gross basis in profit or loss.
- ▶ Since Lessor elected the practical expedient not to separate, variable payments for property taxes, insurance and CAM are considered variable lease payments and are recognized in accordance with paragraph 842-30-25-11(b), which is when the changes in facts and circumstances on which the variable payments are based occur.

**EXAMPLE 5C - LEASE OF OFFICE SPACE (*CONTINUED*) - LESSOR ACCOUNTING, PRACTICAL EXPEDIENT NOT TO SEPARATE IS NOT ELECTED**

**FACTS**

- ▶ Let's continue Example 5 in which Lessor and Lessee enter into a five-year lease for one floor in a 30-story office building in New York City.
- ▶ The lease requires Lessor to perform common area maintenance (CAM) services.
- ▶ The contract requires Lessee to pay rent of \$50,000 per month in arrear and to reimburse Lessor for Lessee's pro-rata share of real estate taxes and insurance incurred by Lessor on the building, and CAM charges.
- ▶ The pro rata share of those reimbursements is initially estimated at \$9,000 per month (\$5,000 for taxes and insurance and \$4,000 for CAM). The CAM charges can be adjusted upward and downward based on actual work performed by Lessor.
- ▶ Assume there are no lease incentives or initial direct costs.
- ▶ Lessor does not elect the practical expedient not to separate for this asset class.

**WHAT ARE THE COMPONENTS?**

- ▶ As previously evaluated in Example 5, the contract includes two components: one lease component (lease of the floor) and one nonlease component (CAM services).
- ▶ Also, Lessor determines under ASC 606 that its CAM services represent a single performance obligation.

**WHAT IS THE CONSIDERATION IN THE CONTRACT?**

- ▶ The consideration in the contract starts with the same amount as determined by Lessee, which is \$50,000 X 12 months X 5years = \$3,000,000.
- ▶ There are also variable payments in the contract. Therefore, Lessor applies the guidance in paragraph 842-10-15-39.
- ▶ Lessor determines that Lessee's payments for CAM services relate specifically to Lessor's efforts to transfer the CAM services.
- ▶ Therefore, Lessor evaluates the variable payments in accordance with the variable consideration guidance in paragraphs 606-10-32-5 through 32-13.
  - Lessor estimates that it will be entitled to receive \$240,000 in variable payments for the CAM services (\$4,000 x 12 x 5years = \$240,000).
  - Lessor also determines that it is probable that including that amount in the consideration would not result in a significant reversal in cumulative revenue when the uncertainty of the payments is resolved.
  - Accordingly, Lessor includes the amount it expects to be entitled to receive for the CAM services of \$240,000 in the consideration in the contract.
- ▶ The other payments Lessee will make to Lessor for its prorata share of real estate taxes and insurance are not based on an index or a rate. They also relate at least partially to the lease component. Accordingly, the expected reimbursement amounts for property taxes and insurance are not included in the consideration in the contract in accordance with paragraph 842-10-15-40.
- ▶ The consideration in the contract for Lessor is \$3,240,000 (\$3,000,000 + \$240,000).

### WHAT ARE THE AMOUNTS ALLOCATED TO THE LEASE COMPONENT?

- ▶ Lessor allocates the consideration in the contract to the lease and nonlease components using the guidance in ASC 606. For example, if the CAM charges are not at their standalone selling price (for example, CAM services are charged at cost without a profit margin), one acceptable allocation approach may be for Lessor to allocate the entire amount of expected CAM reimbursements to the CAM component, plus a portion of the fixed consideration to reflect an appropriate profit margin on the CAM services, if that reasonably depicts the consideration Lessor expects to be entitled for each of the lease component and CAM component.
- ▶ The amount of the consideration in the contract allocated to the lease component is then used to account for the lease component under ASC 842 (e.g., assess lease classification, recognize lease revenue on a straight-line basis over the lease term if an operating lease, etc.).
- ▶ The amount of consideration allocated to CAM services is accounted for in accordance with the guidance on satisfaction of performance obligations in paragraphs 606-10-25-23 through 25-37. In this case, Lessor determines that CAM services are provided over time, using a time-based measure of progress (i.e., on a straight-line basis).
- ▶ Lessor will consider the guidance on variable consideration in ASC 606 and update the amounts it expects to be entitled for CAM services each reporting period. Lessor will allocate those changes consistent with its initial allocation. For example, if Lessor initially allocated the estimated CAM payments entirely to the CAM component, subsequent changes to that estimate may be allocated entirely to the CAM component.
- ▶ Because Lessee reimburses Lessor for property taxes and insurance (as opposed to paying directly a third-party), Lessee's payments for its prorata share of those activities are considered lessor costs in accordance with paragraph 842-10-15-40A and are recognized on a gross basis in profit or loss.
- ▶ Also, Lessor will allocate the variable payments for property taxes and insurance to the lease and nonlease components in accordance with paragraph 842-10-15-40; that is, on the same basis as the initial allocation of the consideration in the contract (or most recent modification not accounted for as a separate contract, if any), unless the variable payment meets the criteria in paragraph 606-10-32-40 to be allocated only to the lease component. For example, Lessor may allocate the entire payments for property taxes and insurance to the lease component if that is consistent with the initial allocation performed and the allocation objective.
- ▶ Then,
  - Variable payment amounts allocated to the lease component are recognized as income in profit or loss in accordance with paragraph 842-30-25-11(b) which is when the changes in facts and circumstances on which the variable payments are based occur.
  - Variable payment amounts allocated to the nonlease component, if any, are recognized in accordance with ASC 606.

### 3.4.4 Remeasuring and Reallocating the Consideration

A lessor remeasures and reallocates the remaining consideration in the contract when there is a contract modification that is not accounted for as a separate contract under paragraph 842-10-25-8. This also includes situations described in paragraph 842-10-35-3 (for example, when the lessee exercises a renewal or purchase option that the lessor previously determined was not reasonably certain of exercise).

Also, a lessor allocates subsequent changes in variable consideration in accordance with the requirements in paragraphs 606-10-32-42 through 32-45. For example, in Example 5C above the lessor included estimated CAM payments in the consideration in the contract. If the estimate subsequently changes, the additional consideration should be allocated to the lease and nonlease components on the same basis that the initial consideration was allocated.

## 3.5 PORTFOLIO APPROACH

Paragraph 120 in the Basis for Conclusions in ASU 2016-02 indicates that ASC 842 permits an entity (lessee or lessor) to apply the leases guidance at a portfolio level for leases with similar characteristics as long as the use of the portfolio approach would not differ materially from the application of ASC 842 to the individual leases in the portfolio. Paragraphs 842-20-55-18 through 55-20 also provide an example in which the portfolio approach is utilized in determining the discount rate for the lease.

The portfolio approach may also be used to account for multiple lease components that have the same characteristics including commencement date, lease term, and lease classification, such as a lease of three vehicles, or a lease of multiple floors in a multi-floor building. However, the application of the portfolio approach could result in additional complexity when the entity applies the subsequent measurement guidance of ASC 842 (for example, for a lessee, on impairment and abandonment considerations, or contract modification considerations - see Chapter 5 for further details).

## 3.6 CONTRACT COMBINATION

Two or more contracts must be combined, at least one of which is or contains a lease, when they are entered into at or near the same time with the same counterparty (or related parties) and consider those contracts as a single transaction if either:

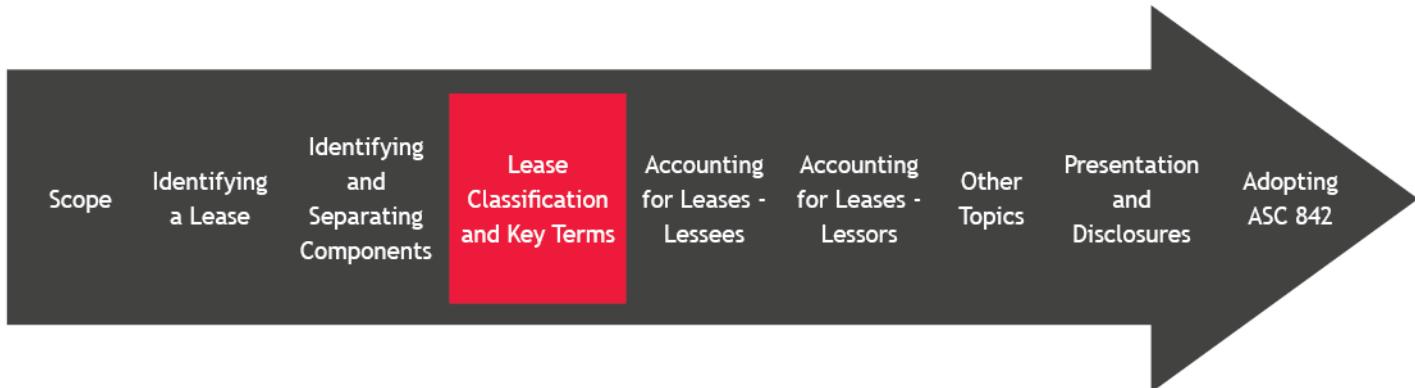
- ▶ They were negotiated as a package with the same commercial purpose,
- ▶ The amount of consideration to be paid in one contract depends on the price or performance of the other one, or
- ▶ The rights to use the underlying assets conveyed in the contracts are a single lease component based on the separation guidance described above.

### BDO INSIGHTS – COMBINATION GUIDANCE ALIGNED WITH REVENUE GUIDANCE

The guidance in paragraph 842-10-25-19 on contract combination is consistent with the guidance in paragraph 606-10-25-9 on combining revenue contracts. This linkage was intentional, as the new lease standard incorporates concepts from the new revenue recognition guidance.



# CHAPTER 4 – LEASE CLASSIFICATION AND KEY TERMS



## 4.1 OVERVIEW

In Chapter 3, we discussed how an entity identifies and separates components in a lease contract. An entity then generally accounts for the lease component(s) under ASC 842, and the nonlease component(s) under other GAAP (e.g., ASC 606 for a lessor). An entity also applies the guidance in ASC 842 at the lease component level, and the accounting for that lease component is governed by how that lease component is classified.

In some cases, however, as we discussed in Chapter 3 an entity may elect a practical expedient by asset class not to separate the nonlease component(s) from the associated lease component. In those situations:

- ▶ A lessee generally applies the practical expedient without regard to conditions, and accounts for the combined component as a single lease component. The lessee then applies the guidance in ASC 842, including lease classification, to that single (combined) lease component. Accordingly, a lessee applies the lease classification guidance after it combines the lease and related nonlease component(s).
- ▶ A lessor must meet certain conditions to apply the practical expedient not to separate. One condition is that the lease component, *if accounted for separately*, would be classified as an operating lease. Accordingly, a lessor applies the lease classification guidance at the individual lease component before it combines the lease and related nonlease component(s). This lease classification assessment will determine whether the lessor meets the scope conditions to apply the practical expedient not to separate. If the lessor meets all the scope conditions, the accounting for the combined component then depends on which component of the contract is predominant. If the nonlease component(s) are predominant, the lessor accounts for the combined component under ASC 606. Otherwise, it accounts for the combined component as an *operating* lease. In other words, a lessor does not reassess lease classification once the components are combined.

This is summarized in the following table:

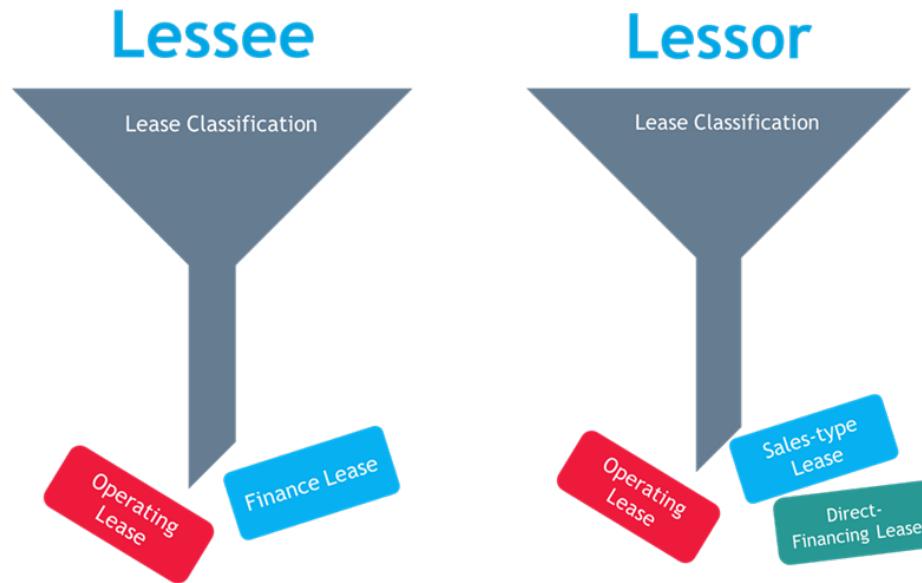
| Lessee   | Lessor  |
|--|---|
| <ul style="list-style-type: none"> <li>▶ Assess lease classification at the <i>combined</i> lease component level, if the lessee elected the practical expedient not to separate for the asset class.</li> </ul> | <ul style="list-style-type: none"> <li>▶ Assess lease classification at the <i>individual</i> lease component level, irrespective of whether the lessor elected the practical expedient to not separate for the asset class.</li> </ul> |

A lease component is initially classified and recognized in the financial statements at the commencement date. For example, a lessee assesses lease classification, and recognizes the lease on balance sheet, at the commencement date. It is therefore important for an entity to appropriately identify that date. That analysis is not always straightforward, including for example when the lease involves construction of improvements.

An entity will also need to answer several other questions to perform the lease classification tests and determine the accounting for the lease component. Some of those questions include:

- ▶ What is the lease term? For example, in a lease with a noncancelable period of five years with a one-year renewal option, is the lease term five years, or six years? What should be considered in making that determination?
- ▶ What are the lease payments? For example, are variable payments based on sales of the lessee included? Do all payments from the lessor to the lessee (e.g., incentives) affect the accounting for the lease component?
- ▶ What is the discount rate for the lease, and how is it determined? For example, is the discount rate for the lease the same for all entities, or are there differences between lessees and lessors, and between public business entities and other entities? Is it based on the lease term, or should it consider other options (e.g., renewal options) not included in the lease term?
- ▶ What is the fair value of the underlying asset? For example, is fair value the same for all entities, whether lessee or lessor, or are there specific exceptions for certain entities (e.g., lessors that are not manufacturers or dealers)?

We will discuss those questions in further detail in this chapter, along with how to determine lease classification once those questions have been answered. For lessees, leases are classified as either an operating or a finance lease. For lessors, leases are classified as either a sales-type, a direct financing, or an operating lease. ASC 842 no longer includes leveraged lease classification for lessors for leases that are entered into or modified after ASC 842's effective date. Existing leveraged leases are grandfathered into ASC 842 and continue to be accounted by the lessor under prior guidance until they expire or are modified.



Note that in this chapter we will discuss only the initial assessment (i.e., at the commencement date). Subsequent changes to the lease term, lease payments, discount rate, etc. are discussed in Chapter 5 for lessees and Chapter 6 for lessors.

## 4.2 COMMENCEMENT DATE



### FASB REFERENCES

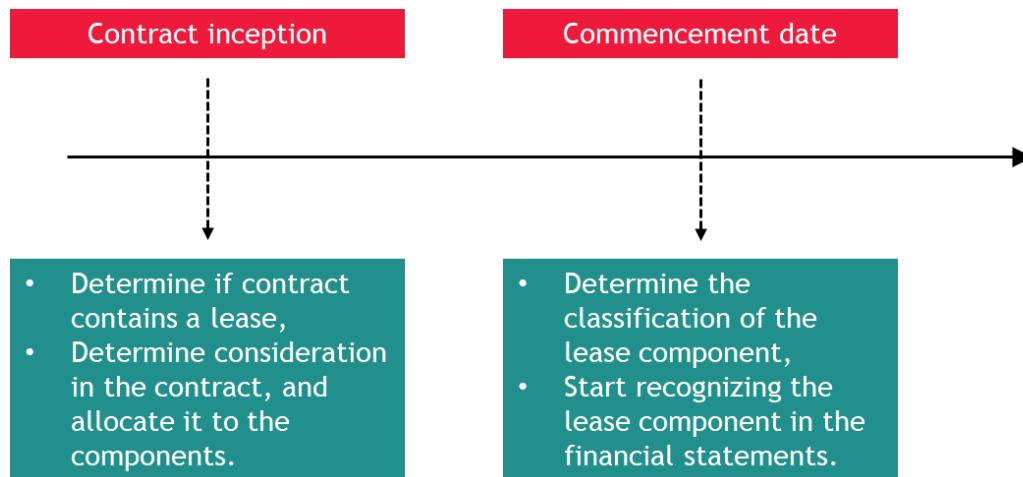
ASC 842-10-20 Glossary

#### Commencement Date of the Lease (Commencement Date)

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

The commencement date of a lease is when the lessee takes possession of or is given control over the use of the underlying asset. The commencement date is not always stated in the contract. Often, a lessee and lessor negotiate an expected commencement date based on availability of the asset. Other times, there will be a contractual commencement date in the contract, but that date may not coincide with the commencement date for accounting purposes. Example documents to consider in determining the commencement date include letters acknowledging the transfer of possession, certificates of occupancy, construction start dates, etc. It is important to note that the commencement date may or may not coincide with the date at which payments under the lease begin.

The commencement date of the lease also may be different from the inception date of the contract, which is usually the date that the contract was executed. ASC 842 makes a distinction between those two dates and provides for different accounting requirements at those two dates as illustrated below.



Paragraph 842-10-55-19 highlights that the lessor makes the underlying asset available for use by the lessee when the lessee is given control over the use of the underlying asset. Accordingly, in evaluating the commencement date of a lease, we believe it is useful to look to the definition of a lease, and more specifically, at what comprises the right to control the use of the asset, which is discussed in paragraph 842-10-15-4. That paragraph provides for two conditions: (a) the right to obtain substantially all of the economic benefits from use of the identified asset, and (b) the right to direct the use of the asset. In many cases, those two conditions are met when the lessee has exclusive use of the asset - even if the lessee is using the period to construct leasehold improvements (lessee assets) and has not yet commenced operations - and therefore the lease typically has commenced at that date.

Sometimes, an agreement may involve leases of multiple assets that are determined to be separate lease components (generally referred to as master lease arrangements). In those cases, there may be multiple commencement dates, which affects the timing of lease classification and recognition of each lease component in the financial statements. Although a master lease agreement may specify that the lessee must take a minimum number of units or dollar value of equipment, there will be multiple commencement dates, unless all of the underlying assets subject to that minimum are made available for use by the lessee on the same date.

**BDO INSIGHTS – ACCOUNTING OWNER OF IMPROVEMENTS AFFECTS COMMENCEMENT DATE AND LEASE PAYMENTS**

Paragraph 842-10-55-19 explains that in some lease arrangements, the lessor may make the underlying asset available for use by the lessee before the lessee begins operations or makes lease payments. During this period, the lessee may have the right to use the underlying asset to construct a **lessee asset** (for example, leasehold improvements). Paragraph 842-10-55-20 then notes that the terms of the contract may vary as to whether the lessee is required to make lease payments before or after construction is completed and the lessee begins operations, but that the timing of the payments does not impact the determination of the lease commencement date.

ASC 842 does not explicitly discuss how to determine whether improvements are a lessee asset or a lessor asset. However, it is important to determine if the improvements relate to a lessee asset (e.g., leasehold improvements), or a lessor asset (e.g., lessor constructs its own improvements, or the lessee performs services on behalf of the lessor) as it may affect the determination of the commencement date, and of the consideration in the contract (and therefore the lease payments). Determining the accounting owner of the improvements will require the use of professional judgment based on the terms of the lease contract and the nature of the improvements made. Questions to consider include, but are not limited to:

- ▶ Does the lease or other contract require the lessee to construct specific improvements, including to the lessor's design? A "yes" answer would be an indicator that the lessor controls the improvements, whereas the lessee's discretion about whether to construct the improvements and/or their design may indicate that the lessee controls the improvements.
- ▶ Is the lessee permitted to remove or alter the improvements without the lessor's approval? A "yes" answer would be an indicator that the lessee controls the improvements.
- ▶ Does the lessor legally own upon completion any improvements, alterations and additions made by the lessee? A "yes" answer would be an indicator that the lessor controls the improvements.
- ▶ Are the improvements specific to the lessee such that they do not have an economic value to the lessor at the end of the lease term (e.g., the lessor would not be able to use the improvements in arrangements with other lessees)? A "yes" answer would be an indicator that the lessee controls the improvements.

If the lessee is the accounting owner of the improvements, any payments from the lessor, including those made directly to a third party providing the construction services, are considered an incentive to the lessee which reduce the consideration in the contract consistent with the guidance in paragraphs 842-10-15-35(a) and 842-10-30-5(a). The lessee being the accounting owner of the improvements also affects the commencement date of the lease, which is when the lessor makes the underlying asset available for use by the lessee (e.g., when the lessee takes possession of the underlying asset and starts constructing its leasehold improvements). There is also no distinction between the right to use the underlying asset during and after the construction period. In other words, lease costs (or income) associated with building and ground leases incurred (or earned) during and after the construction is complete are both for the right to use the underlying asset and therefore are recognized by the lessee (or lessor) in accordance with the guidance in Subtopics 842-20 and 842-30, respectively. The timing of when lease payments begin does not affect the commencement date.

If the lessor is the accounting owner of the improvements, payments made by the lessor generally do not affect the consideration in the contract (e.g., payments from the lessor to the lessee to reimburse the lessee for costs incurred on behalf of the lessor to construct the lessor asset). But in that scenario, the commencement date of the lease will likely not occur until construction of the lessor improvements is substantially complete, and the lessee obtains control over the use of the underlying asset, including the improvements. Also, lessee payments for the right to use the underlying asset are lease payments, regardless of the timing of those payments or the form of those payments.

**EXAMPLE 1 - RETAIL STORE****FACTS**

- ▶ Retail Lessee enters into a lease with Realty Lessor on December 1, 2019 for the use of a retail store for five years.
- ▶ As part of the contract, Realty Lessor pays Retail Lessee \$50,000 as reimbursement for improvements to the retail space, which are specific to Retail Lessee. Retail Lessee has the right to remove or alter the improvements made throughout the lease term without Realty Lessor's permission.
- ▶ Realty Lessor gives Retail Lessee the keys to the store on January 1, 2020, at which point Retail Lessee can start constructing the improvements.
- ▶ Retail Lessee completes the construction of the improvements, and opens its retail store, on March 1, 2020.
- ▶ The contract requires Retail Lessee to make monthly payments in arrears of \$10,000 starting on March 31, 2020.

**WHO IS THE ACCOUNTING OWNER OF THE IMPROVEMENTS?**

- ▶ Retail Lessee is the accounting owner of the improvements because the improvements are specific to Retail Lessee's brand and therefore the improvements could not be used by Realty Lessor in arrangements with other lessees. Retail Lessee also has the right to remove or alter the improvements at any time during the lease term without Realty Lessor's permission.
- ▶ Because Retail Lessee is the accounting owner of the improvements, the \$50,000 payment from Realty Lessor to Retail Lessee is a lease incentive in accordance with paragraph 842-10-55-30.
- ▶ The lease incentive reduces the consideration in the contract, and reduces the amounts allocated to the lease component and nonlease component(s), if any.
- ▶ Retail Lessee separately accounts for the leasehold improvements as an asset in accordance with ASC 360.

**WHAT IS THE COMMENCEMENT DATE?**

- ▶ Since Retail Lessee is the accounting owner of the improvements, the commencement date of the lease is January 1, 2020, which is the date at which Realty Lessor makes the space available for use by Retail Lessee and at which point Retail Lessee can start constructing its improvements. Starting at that date, including during the construction of its leasehold improvements, Retail Lessee has exclusive use of the retail store and directs its use.
- ▶ In accordance with paragraph 842-10-55-20, the timing of when Retail Lessee is required to make lease payments is not relevant to this analysis. Recognition of the lease liability and right-of-use asset, as well as lease expense, begins on January 1, 2020.

**EXAMPLE 2 - MEDICAL OFFICE BUILDING****FACTS**

- ▶ Medical Lessee enters into a lease with Healthcare Lessor on December 1, 2018 for the use of a medical office building for ten years.
- ▶ At contract inception, the medical office building was in relatively poor condition, and required significant renovations. As part of the negotiations with Medical Lessee, Healthcare Lessor agrees to spend up to \$6.0 million to renovate the building, including mechanical upgrades, roof replacement, replacing and reconfiguring certain interior walls, and making other improvements. The renovations are expected to take between 12 to 15 months.
- ▶ The lease indicates that all improvements are the legal property of Healthcare Lessor, and Medical Lessee cannot remove or alter the improvements during the lease term without Healthcare Lessor's approval, which Healthcare Lessor may reject at its sole discretion.
- ▶ The improvements have an average expected economic life of 20 years and are not specific to Medical Lessee. That is, the improvements could be used by Healthcare Lessor in arrangements with other lessees operating in the medical and healthcare industry.
- ▶ Healthcare Lessor provides Medical Lessee with limited access to the building on October 31, 2019 so that Medical Lessee can inspect the renovations and plan for construction of its own leasehold improvements. However, Medical Lessee does not yet have the right to construct its leasehold improvements.
- ▶ Healthcare Lessor substantially completes the renovations on January 1, 2020, at which point Medical Lessee is given full access to the building to install its own leasehold improvements.
- ▶ Medical Lessee starts operations in the building on March 1, 2020.
- ▶ The contract requires Medical Lessee to make monthly payments in arrears of \$150,000 once construction is substantially complete, with fixed annual increases of 5%.

**WHO IS THE ACCOUNTING OWNER OF THE IMPROVEMENTS?**

- ▶ Healthcare Lessor is the accounting owner of the improvements (renovations) because the improvements are not specific to Medical Lessee. Healthcare Lessor can use the improvements at the end of the lease term for other lessees in the medical and healthcare field. Healthcare Lessor also controls whether alterations are made to the improvements and is the legal owner of the improvements.
- ▶ Healthcare Lessor's payments for the improvements do not affect the consideration in the contract and the lease payments.

**Note 1:** We believe the above conclusions would be true even if Medical Lessee made the improvements on behalf of Healthcare Lessor and Healthcare Lessor reimbursed Medical Lessee for costs incurred on its behalf because, in substance, Medical Lessee acted as an agent for Healthcare Lessor.

**Note 2:** If Medical Lessee made payments to Healthcare Lessor to fund some or all of the construction costs related to the improvements owned by Healthcare Lessor, those payments would be considered lease payments (assuming there are no nonlease components). This is because payments by a lessee for the right to use the underlying asset are lease payments, regardless of the timing of those payments or the form of those payments. Alternatively, if Healthcare Lessor also constructed Medical Lessee's improvements on its behalf, then any related payments would be accounted for under ASC 360 by Medical Lessee. It may require judgment in order to determine which payments relate to the lease and which relate to assets owned by the lessee in similar situations.

**WHAT IS THE COMMENCEMENT DATE?**

- ▶ Since Healthcare Lessor is the accounting owner of the improvements, the commencement date of the lease is January 1, 2020, which is the date at which Healthcare Lessor substantially completes the improvements and makes the space available for use by Medical Lessee.

- ▶ The lease does not commence on October 31, 2019 because Healthcare Lessor only provides limited access to Medical Lessee (for it to plan for its own leasehold improvements). From October 31, 2019 up to January 1, 2020, Medical Lessee does not obtain substantially all of the economic benefits from use of the building, nor does it direct its use.
- ▶ The date at which Medical Lessee starts operations is also not relevant in determining the commencement date, consistent with paragraph 842-10-55-19. This is because Medical Lessee has exclusive use of the building and directs its use even during the construction of its own leasehold improvements.

### EXAMPLE 3 - RESTAURANT SPACE

#### FACTS

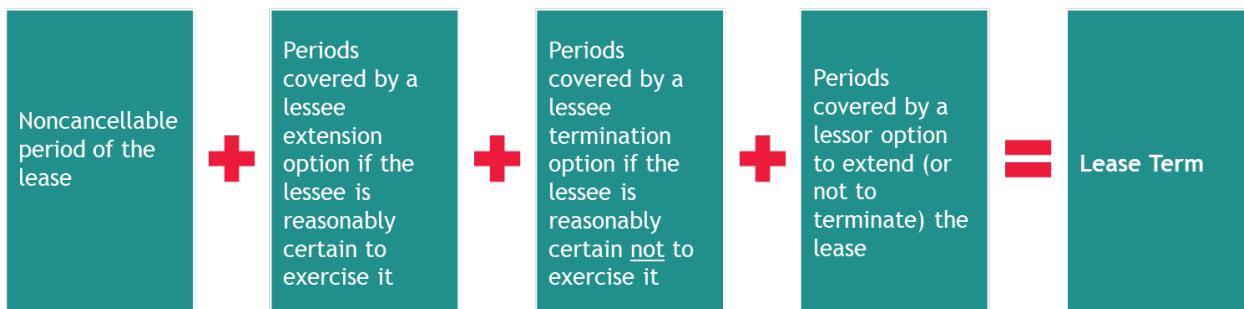
- ▶ Burgers R Us enters into a lease for a new restaurant on May 1, 2019, at which time both lessee and lessor begin the work to obtain the relevant permits required to operate a Burgers R Us restaurant in that location.
- ▶ The lease provides for payments of \$16,000 per month if Burgers R Us begins operations in the location on or before November 1, 2019. Monthly lease payments increase by \$500 for every month the grand opening is delayed beyond November 1, 2019.
- ▶ The lease term ends ten years after the first payment, which is due when the restaurant opens for business.
- ▶ The relevant permits are obtained, and the lessor grants access to Burgers R Us to the site on August 1, 2019. At that time, Burgers R Us begins constructing leasehold improvements to conform the building to its brand requirements. Assume the improvements are a lessee asset.
- ▶ The restaurant opens for business on December 1, 2019, at which time payments under the lease begin.

#### WHAT IS THE COMMENCEMENT DATE?

- ▶ The commencement date of the lease is August 1, 2019 because it is the date at which Burgers R Us has the right to control access to and use of the building, as evidenced by its starting construction of leasehold improvements.
- ▶ In accordance with paragraph 842-10-55-20, the timing of when Burgers R Us is required to make lease payments is not relevant to this analysis. However, because Burgers R Us does not know at lease commencement when lease payments will begin and, therefore, what the payment amounts will be and what the end of the lease term is; the total payments and term must be estimated. Burgers R Us should update its estimates and remeasure the payments when the contingency upon which the payments are based is resolved (i.e., when Burgers R Us begins operations) to reflect any difference between the estimates at lease commencement and the final determinations.

## 4.3 LEASE TERM

The lease term begins at the commencement date and includes any rent-free periods provided to the lessee by the lessor. Paragraph 842-10-30-1 addresses how to determine the lease term as follows:



The following table provides additional guidance on how to determine the lease term:

| STEP   | ADDITIONAL GUIDANCE   |
|--|---|
| Determine the noncancelable period of the lease.   | Paragraph 842-10-55-23 explains that when an entity assesses the length of the noncancelable period of a lease, it should apply the definition of a contract and determine the period for which the contract is enforceable. See below for additional discussion and analysis.  |
| If there is a lessee extension option, determine if the lessee is <b>reasonably certain</b> to exercise the option. If so, the extension period is included in the lease term.                               | <p>“Reasonably certain” is a high threshold that is intended to be interpreted consistently with “reasonably assured” under ASC 840 and is generally understood to be as encompassing economic compulsion. However, ASC 842 provides the following additional implementation guidance: In determining whether it is reasonably certain that a lessee option will be exercised (or not exercised), an entity considers all relevant economic and contractual factors (contract-based, asset-based, entity-based, and market-based) consistent with paragraph 842-10-55-26, which include:</p> <ul style="list-style-type: none"> <li>▶ Contractual terms and conditions, such as amount of lease payments or variable lease payments in optional periods compared with current market rates,</li> <li>▶ Significant leasehold improvements that are expected to have significant economic value for the lessee when the lessee option becomes exercisable,</li> <li>▶ Costs related to exiting the lease and signing a new lease, including negotiating costs, relocation costs, costs of returning the underlying asset in a contractually specified condition and/or location, installation costs for the new leased asset, and</li> <li>▶ The importance of the underlying asset to the lessee’s operations, including whether the asset is specialized and/or in a remote location, lost revenue or other economic losses (e.g., when the lessee does not have an equivalent asset and must identify and locate a replacement asset).</li> </ul> |
| If there is a lessee termination option, determine if the lessee is <b>reasonably certain not</b> to exercise the option. If so, the period covered by the termination option is included in the lease term. | <p><b>⚠ JUDGMENT REQUIRED IN ASSESSING ‘REASONABLY CERTAIN’ THRESHOLD</b></p> <p>The assessment requires the use of professional judgment and will often consider a combination of the above factors, along with how far in the future the option is exercisable (for example, an option exercisable in one year versus one exercisable in five or 10 years). All things equal, the further away the option is exercisable, the more evidence will be needed to conclude that a lessee is reasonably certain to exercise (or not exercise) the option. Also, an expectation of exercise alone (and without a significant economic incentive to do so) is not sufficient, and a company’s history of exercising renewal options may not indicate the existence of significant economic factors, and therefore should not be determinative.  </p> <p>See also Example 26 in ASC 842-10-55 for an illustration of the assessment of a lessee termination option.</p>   |
| If there are periods covered by a lessor option to extend (or not to terminate), include those periods in the lease term.  | Periods controlled by a lessor are included in the lease term, irrespective of likelihood of exercise.  |

### BDO INSIGHTS – NONCANCELLABLE PERIOD AND ENFORCEABILITY OF THE CONTRACT

Assessing the noncancelable period and enforceability of a lease are critical in the determination of the lease term. A lease is no longer enforceable when **both** the lessee and the lessor each have the right to terminate the lease without permission from the other party with no more than an insignificant penalty. Thus, the lease term cannot be longer than the enforceable period of the contract. For example, assume a lease that has an initial term of five years that neither the lessee nor the lessor can cancel and, after the initial five years, the lessee has a one-year extension option. In this example the noncancelable period of the lease is five years, and the lease is enforceable for six years because if the lessee elects to extend the lease for one year after the initial term, the lessor is obligated to make the underlying asset available for use by the lessee. Once the noncancelable and enforceable periods are determined, the entity can then assess the lease term, which will either be five years (the noncancelable period only) or six years (the noncancelable period plus the one-year extension period) depending on whether the lessee is reasonably certain to extend; but the lease term cannot be longer than six years (the period the contract is enforceable).

The enforceability of a contract depends in part on whether both parties can cancel the contract with no more than an insignificant penalty. The term penalty is not limited to cash payments nor contractual penalties, but is more broadly defined as shown below:

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

- ▶ Disburse cash
- ▶ Incur or assume a liability
- ▶ Perform services
- ▶ Surrender or transfer an asset or rights to an asset or otherwise forego an economic benefit or suffer an economic detriment. Factors to consider in determining whether an economic detriment may be incurred include, but are not limited to, all of the following:
  - The uniqueness of purpose or location of the property
  - The availability of a comparable replacement property
  - The relative importance or significance of the property to the continuation of the lessee's line of business or service to its customers
  - The existence of leasehold improvements or other assets whose value would be impaired by the lessee vacating or discontinuing use of the leased property
  - Adverse tax consequences
  - The ability or willingness of the lessee to bear the cost associated with relocation or replacement of the leased property at market rental rates or to tolerate other parties using the leased property.

If only the lessee has the right to terminate a lease, it is evaluated like an option to terminate consistent with the previous table.

If only the lessor has the right to terminate the lease, the lease term includes the period covered by the option to terminate the lease.

**EXAMPLE 1 - RETAIL STORE (*CONTINUED*)****FACTS**

- ▶ Let's continue with Example 1 in which Retail Lessee enters into a lease with Realty Lessor for the use of a retail store for five years and for which Retail Lessee must pay \$10,000 monthly in arrears.
- ▶ The initial term of five years cannot be terminated by either party.
- ▶ The contract includes two one-year extension options. If Retail Lessee elects to extend the term, it must pay \$11,000 monthly in arrears in the first extension period, and \$12,000 in the second extension period.

**WHAT IS THE LEASE TERM?**

- ▶ The starting point is to determine the noncancelable period of the lease. In this example, it is five years.
- ▶ Then, Retail Lessee and Realty Lessor each evaluate Retail Lessee's extension options. In this example, there are no economic factors that would indicate Retail Lessee is reasonably certain to exercise its extension options, and, therefore, both Retail Lessee and Realty Lessor conclude that Retail Lessee is not reasonably certain to extend the lease for either one or two years.
- ▶ Accordingly, the lease term is initially five years.

**EXAMPLE 1A - RETAIL STORE (*CONTINUED*)****FACTS**

- ▶ Assume the same as in Example 1, except that:
  - The lease has a fixed term of five years, but there are no extension options. Instead, Retail Lessee can terminate the lease with a six months' notice prior to exiting the space.
  - There is no stated termination penalty for Retail Lessee should it decide to exit the space early.
  - Retail Lessee did not construct significant leasehold improvements because the store is in a new geographical area and market that Retail Lessee is testing.

**WHAT IS THE LEASE TERM?**

- ▶ In this example, Retail Lessee has no significant economic penalty that would require it to stay in the lease for longer than the notice period. As such, the lease term is initially six months.

**EXAMPLE 1B - RETAIL STORE (CONTINUED)****FACTS**

- ▶ Assume the same as in Example 1, except that:
  - The lease has a fixed term of five years, but after the fifth year, the lease converts to a month-to-month arrangement with rent at \$11,000 per month in arrears.
  - Either party can cancel the lease after the initial term without permission from the other party. There is no stated penalty in the contract for canceling.
  - The retail location is important to Retail Lessee, and it constructed significant leasehold improvements such as retail shelving, reception counters, and other layout and design specific to Retail Lessee, for which Realty Lessor did not provide reimbursement to Retail Lessee.
  - If Retail Lessee were to terminate the lease before the end of the eighth year, the shelving and other leasehold improvements would be dismantled and abandoned prior to the end of their useful lives, and Retail Lessee would incur a more than insignificant economic penalty.

**WHAT IS THE LEASE TERM?**

- ▶ The starting point is to determine the noncancelable period of the lease and how long the contract is enforceable. Consistent with paragraph 842-10-55-23, an entity applies the definition of a contract and determines the period for which the contract is enforceable. A lease is no longer enforceable when both the lessee and the lessor each have the right to terminate the lease without permission from the other party with no more than an insignificant penalty.
- ▶ The determination of whether a penalty exists, and its magnitude, are important and require the use of professional judgment. In this example, the presence of significant leasehold improvements results in Retail Lessee incurring a more than insignificant penalty through the end of the eighth year. Therefore, based on the economic penalty the lessee would continue to renew (not cancel) the contract on a month-to-month basis through the end of the eighth year and thus the contract is enforceable for eight years.
- ▶ After the eighth year, the contract is no longer enforceable because either party may terminate the lease without permission from the other with no more than an insignificant penalty.
- ▶ Retail Lessee also determines that it is reasonably certain not to terminate the lease until the end of the eighth year.
- ▶ The fact that Realty Lessor could terminate the lease between the end of the fifth year and eighth year is not relevant because the lease term includes any periods covered by a lessor's option to terminate the lease in accordance with paragraph 842-10-30-1c.
- ▶ Accordingly, the lease term is initially eight years.

**EXAMPLE 1C - LEASE WITH NONCONSECUTIVE PERIODS****FACTS**

- Assume the same as in Example 1, except that:
- Retail Lessee specializes in selling accessories (tablecloths, décor, etc.) for Thanksgiving.
  - The contract with Realty Lessor is for a space in a shopping mall, rather than a specific retail store, and the contract meets the definition of a lease.
  - The lease has a fixed term of five years, but Retail Lessee controls the use of the space in the mall only during the months of October and November of each year.
  - There are no extension or termination options.

**WHAT IS THE LEASE TERM?**

- The definition of a lease in ASC 842 depends in part on whether the customer has the right to control the use of an identified asset throughout the period of use (paragraph 842-10-15-4). The “period of use” is defined as the total period of time that an asset is used to fulfill a contract with a customer (including the sum of any nonconsecutive periods of time).
- As noted previously, the lease term includes the noncancelable period for which the lessee has the right to use an underlying asset. If the period of use of a lease includes nonconsecutive periods, the lease term will also include those nonconsecutive periods. Conversely, the lease term cannot include periods for which a lessee does not have the right to use the underlying asset (in this example, the months other than October and November, for which Realty Lessor has the right to lease the space to other lessees).
- Accordingly, the lease term is the aggregate period of use for which Retail Lessee has the right to use the underlying asset, which in this example is two months per year for five years, for a total of a ten-month lease term.

**EXAMPLE 1D - RETAIL STORE (CONTINUED)****FACTS**

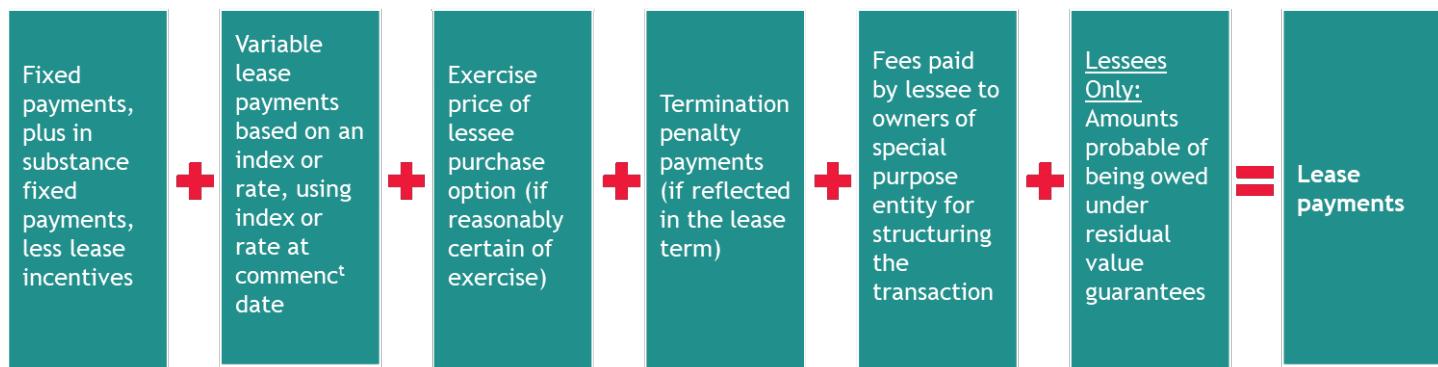
- Assume the same as in Example 1, except that:
- The lease is initially for five years, and neither party can cancel the lease without significant cancellation fees.
  - After the initial term, there are two additional extension periods. However, Retail Lessee and Realty Lessor must both agree on the renewal terms, including rental payments.
- There is no penalty to either party for not agreeing to one or both of extension options.
- There are ample other retail stores or spaces that are available in the marketplace to consider after the fifth year.

**WHAT IS THE LEASE TERM?**

- The lease term is the noncancelable period of five years as neither party can cancel the lease without significant cancellation fees.
- Since both parties must agree on the terms of the renewal period, including rental payments, the periods after the initial term are not enforceable and therefore are not included in the lease term. The lease term is five years.

## 4.4 LEASE PAYMENTS

Once the lease term is identified, the lease payments can be determined. Paragraph 842-10-30-5 defines lease payments, which are the following payments related to the use of the underlying asset during the lease term:



| STEP  | ADDITIONAL GUIDANCE  |
|---|--|
| Determine the fixed payments, including in-substance fixed payments, less lease incentives paid or payable to the lessee. | <ul style="list-style-type: none"> <li>▶ In-substance fixed payments are payments that may appear to contain variability, but they are <b>unavoidable</b>. Examples include:           <ul style="list-style-type: none"> <li>• Payments with no genuine variability (i.e., clauses with no economic substance).</li> <li>• Lower of set of payments for which the lessee has a choice, but it must make at least one set of payments.</li> </ul>           See below for further discussion of in-substance fixed payments.</li> <li>▶ In some leases, the lessee may provide noncash consideration (e.g., equity shares of the lessee). Noncash lease payments should be treated the same as cash for purposes of determining whether they represent fixed payments or variable payments. See also below for further discussion.</li> <li>▶ Deduct lease incentives paid or payable to the lessee, which include:           <ul style="list-style-type: none"> <li>• Payments made to (or on behalf of) the lessee,</li> <li>• Losses incurred by the lessor for assuming a lessee's preexisting lease.</li> </ul>           See <i>Section 4.2 for a discussion of the assessment of the accounting owner of improvements, which affects whether payments by the lessor are considered lease incentives</i>.         </li> </ul> <p><i>See Example 4 below for whether certain lease incentives are considered payable.</i></p> |
| Add variable lease payments based on an index or a rate.  | <ul style="list-style-type: none"> <li>▶ Variable payments based on an index or a rate are included using the index or rate at the commencement date.</li> <li>▶ Examples of variable payments based on an index or a rate include payments based on the consumer price index (CPI), the London Interbank Offered Rate (LIBOR) or Secured Overnight Financing Rate (SOFR), and payments based on changes in fair market rental rates.</li> <li>▶ Subsequent changes in the index or rate are generally recognized as variable lease payments. See Chapter 5 for lessees and Chapter 6 for lessors for further details.</li> <li>▶ See Example 25 Case A in ASC 842-10-55 for an illustration of the accounting for variable lease payments based on an index or a rate.</li> </ul>   |

| STEP  | ADDITIONAL GUIDANCE  |
|---|--|
| <b>Add</b> the exercise price of a lessee purchase option (if reasonably certain of exercise).                        | <ul style="list-style-type: none"> <li>▶ Assess the lessee purchase option the same way as a lessee extension or termination option, as discussed in Lease Term section above. Because “reasonably certain” is a high threshold, also consider the significance of any discount between the fixed price of the purchase option and the expected fair value of the underlying asset when the option is exercisable, and how consistent expected values have historically been for the underlying asset.</li> <li>▶ See Examples 23 and 24 in ASC 842-10-55 for illustrations of the assessment of lessee purchase options.</li> </ul> |
| <b>Add</b> termination penalty payments (if reflected in the lease term).   | <ul style="list-style-type: none"> <li>▶ See Lease Term section above for discussion of lessee termination options.</li> </ul>   |
| <b>Add</b> fees paid by lessee to owners of special purpose entity for structuring the transaction.                   | <ul style="list-style-type: none"> <li>▶ Note that the fees are added to the lease payments but are excluded from the fair value of the underlying asset.</li> </ul>   |
| <b>For lessees only</b> , determine and <b>add</b> the amount probable of being owed under residual value guarantees. | <ul style="list-style-type: none"> <li>▶ “Probable” means that the future event or events are likely to occur.</li> <li>▶ This requirement is applicable for lessees only.</li> <li>▶ See below for discussions on in-substance residual value guarantees and other guarantees provided by a lessee.</li> </ul>  |

### BDO INSIGHTS – NONCASH LEASE PAYMENTS

In some instances, the lessee may provide noncash consideration to the lessor in lieu of cash lease payments for the right to use the underlying asset. For example, the lessee may grant equity instruments to the lessor, or it may contribute goods or services (for example, materials, equipment, or labor) to facilitate the construction of the lessor controlled asset, as payment for the use of the underlying asset.

In those situations, we believe the entity (lessee or lessor) should generally recognize the fair value of the noncash consideration as lease payments, unless specifically excluded from the definition of lease payments.

It is also important for the entity to assess whether the transfer of noncash assets is within the scope of other accounting standards. For example, if the lessee issues shares or other equity instruments such as warrants to the lessor, that grant will be in the scope of ASC 718 on stock compensation subsequent to the adoption of ASU 2018-07, *Compensation - Stock Compensation: Improvements to Nonemployee Share-Based Payment Accounting*. ASC 718 addresses measurement and classification (equity versus liability) of the award but does not address the periods or the manner (capitalize versus expense) in which an entity granting the share-based payment award to a nonemployee should recognize the cost of the share-based payment award that will be issued. It only requires that an asset or expense be recognized (or previous recognition reversed) in the same periods and in the same manner as if the grantor had paid cash for the goods or services instead of paying with or using the share-based payment award.

The following are **not** considered lease payments:

- ▶ Variable lease payments other than those based on an index or a rate (e.g., payments based on either percentage of sales of the lessee, energy produced by a solar farm, units produced by a machinery, etc.). Such payments based on performance of the asset are considered variable lease payments, even if there is a high likelihood based on historical and other data that a certain level of sales, energy or units, will be produced. This is because those payments relate directly and proportionately to the use or performance of the underlying asset. In other words, those variable payments have economic substance. However, if lease payments are a fixed percentage of sales of the lessee subject to a floor, such as \$1,000, the \$1,000 floor represents an unavoidable payment that should be included as lease payments.
- ▶ Lessee guarantees of the lessor's debt, which a lessee generally accounts for under ASC 460 on guarantees. However, consistent with practice under ASC 840, if the guarantee is in-substance a residual value guarantee, a lessee should apply the guidance in the table on the previous page on estimating amounts probable of being owed under residual value guarantees. This could occur for example if the lender has recourse only to the leased asset (i.e., the debt is nonrecourse to the lessor), or if the lessor entity does not have significant assets other than the underlying asset subject to the lease.



#### LEASE PAYMENTS ARE AN ALLOCATED AMOUNT OF THE CONSIDERATION IN THE CONTRACT

Remember that the amount of lease payments results from an *allocation* of the consideration in the contract to the lease and nonlease component(s). Amounts allocated to the nonlease components are therefore not considered lease payments, unless:

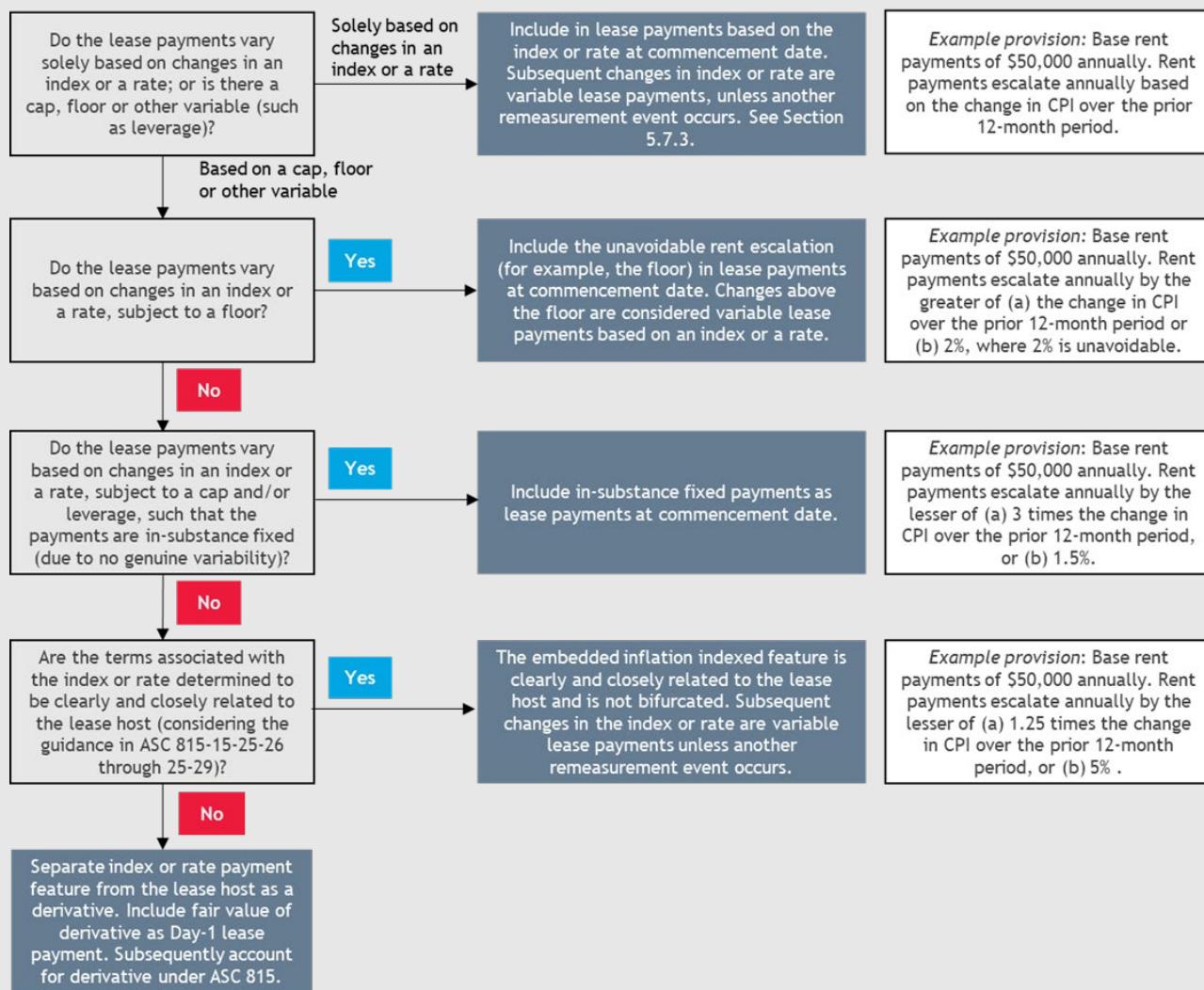
- ▶ For a lessee, it elected the practical expedient not to separate for the asset class.
- ▶ For a lessor, it elected the practical expedient not to separate for the asset class, it met the scope conditions, and the nonlease component(s) are not the predominant component(s).

See Chapter 3 for further discussion of separation of components, allocation of the consideration in the contract to the components, and the lessee and lessor practical expeditents not to separate.

### BDO INSIGHTS – IDENTIFYING UNAVOIDABLE FIXED PAYMENTS

Leases may include in-substance fixed payments and other unavoidable payments that must be included in the lease payments. Examples of in-substance fixed payments include payments that require the lower of two payments to be made when a lessee has a choice about a set of payments it makes and payments that do not create genuine variability (such as those that result from clauses that do not have economic substance). Reviewing the terms of the lease are important, and an entity should focus on identifying payments that are unavoidable. For example, if a lease contract includes payments based on the lower of (a) X times a change in CPI, and (b) Y% (a fixed percentage), this may not have any economic substance if based on historical changes in the CPI, the application of the leverage (X) results in Y% always being reached. In those situations, the increase based on Y% should be included in the lease payments. As another example, in a lease whereby lease payments increase by the greater of (i) the change in CPI, or (ii) a fixed percentage, such as 2%, the payments will always increase by at least 2%, making an increase of 2% an unavoidable payment that should be included as lease payments.

When assessing whether payments are unavoidable and thus represent in-substance fixed payments, an entity should determine whether there is a minimum or floor amount that the lessee must pay, or whether contract terms that purport variability in payments lack economic substance. Common phrases to look for in leases that may signal those payments or require further analysis include: "...the greater of...", "...not to be less than ...", "...minimum amount of ...", and "...the lesser of...". The following flowchart illustrates steps an entity may find helpful when determining the accounting treatment of certain payment provisions based on an index or a rate:



## EXAMPLE 4 - ACCOUNTING FOR CONTINGENT LEASE INCENTIVES

### FACTS

- ▶ Lessee enters into a lease contract with a lessor for a retail store.
- ▶ The lease is an operating lease and there are no nonlease components.
- ▶ Lessee is entitled to a lease incentive from the lessor for leasehold improvements, which are to be constructed by Lessee.
- ▶ At the commencement date of the lease, Lessee intends to construct the improvements, the construction is within its control, and it is reasonably certain that the cost of the improvements will equal or exceed the maximum incentive amount specified in contract.
- ▶ Lessee completes the improvements two months after the commencement date of the lease.

### HOW SHOULD LESSEE ACCOUNT FOR THE CONTINGENT LEASE INCENTIVE?

#### Scenario 1 - Monthly rent is a fixed amount and the lease payments exceed the lease incentive amount

- ▶ We believe one acceptable approach would be to include the lease incentive amount as being receivable at the commencement date. In this situation, the lease incentive is included in the determination of the lease payments at the commencement date, which will affect the initial measurement of the lease liability and the right-of-use asset (essentially reduce the amounts reported on the balance sheet).
- ▶ We believe it would also be acceptable to account for the lease incentive as a contingent lease incentive which is not included in the lease payments at the commencement date, but for which the lessee applies paragraph 842-10-35-4(b) on resolution of a contingency. In that case, the lessee would remeasure the lease payments when the contingency on which the variable lease incentive is based is resolved.

#### Scenario 2 - Monthly rent is a fixed percentage of lessee's gross sales each month

- ▶ Because the payments to the lessor are entirely variable, there are no lease payments at the commencement date in accordance with paragraph 842-10-30-6(a).
- ▶ Because ASC 842 does not specifically address this question, we believe there are two approaches to accounting for these contingent lease incentives (like in scenario 1 above). However, the analysis differs from scenario 1 because in this scenario there are no lease payments (i.e., there is no lease liability or right-of-use asset against which to offset the lease incentive amounts):
  - **Approach 1:** Consider the lease incentive as being receivable at the commencement date. Therefore, recognize a lease receivable and a corresponding liability for the lease incentive at the commencement date. When/as the lessor reimburses the lessee, the lessee reduces the amount of the lease receivable initially recognized. The liability should be reduced on a straight-line basis over the lease term as an offset to lease expense, not to exceed the amount of lease expense recognized for the current period.
  - **Approach 2:** Lessee does not recognize any lease incentive at the commencement date. When the contingency on which the lease incentive is based is resolved, the lessee would remeasure the lease payments. Since there continues to be no lease payments other than the incentive, we believe the recognition of the incentive should be recorded as a liability, rather than as a contra-asset (i.e., a right-of-use asset that is less than zero). The liability should then be reduced on a straight-line basis over the lease term as an offset to lease expense, not to exceed the amount of lease expense recognized for the current period.

#### 4.4.1 Residual Value Guarantees

As previously discussed, a lessee includes in the lease payments the amounts probable of being owed under residual value guarantees. However, there may be additional factors for a lessee to consider, depending on the terms of the lease contract:

| FACTS  | ANALYSIS  |
|--|---|
| <p><b>Contract requires the lessee to make up a residual value deficiency for damage, extraordinary wear and tear, or excessive usage.</b></p> <p><b>Contract provides for lessor the right to require lessee to purchase the underlying asset by the end of the lease term.</b></p> <p><b>Lessee obtains a residual value guarantee from an unrelated third-party for lessor's benefit.</b></p> | <p>This provision does not constitute a lessee residual value guarantee. Any payments are instead treated like variable lease payments.</p> <p>The lessee is obligated (i.e., it is outside its control) to pay the guaranteed residual value. Therefore, the stated purchase price is included in lease payments.</p> <p>The existence of a third-party guarantee should not reduce the estimate of lessee's amounts probable of being owed under residual value guarantees, unless the lessor releases the lessee from obligation (including secondary obligation). Also, the amounts paid by a lessee for third-party residual value guarantees are executory costs of the lessee (i.e., they are not included in lease payments).</p> |

#### 4.4.2 Obligations Imposed at End of Lease Term

Some lease contracts impose obligations on the lessee to return the underlying asset to specific conditions at the end of the lease term. The accounting for such obligations depends on which asset (lessor or lessee asset) the obligation relates to:

- ▶ If the lessee has an obligation to return the underlying asset to its original condition because the lessee modified it (i.e., a lessee asset such as lessee installed leasehold improvements), payments to repair the underlying asset generally do not meet the definition of lease payments or variable lease payments. Instead, the obligation is accounted for under ASC 410-20 on asset retirement and environmental obligations.
- ▶ If the lessee has an obligation for costs to dismantle and remove the underlying asset at the end of the lease term (i.e., a lessor asset), those costs generally are considered lease payments or variable lease payments. Because the accounting for such payments is governed by ASC 842, the guidance in ASC 410-20 does not apply, as noted in paragraph 410-20-15-3(e).

#### 4.4.3 Tax Benefit Indemnifications

Some leases contain indemnification clauses that indemnify a lessor on an after-tax basis for certain tax benefits that the lessor may lose if a change in the tax law precludes realization of those tax benefits. Those payments are not of the nature normally expected to arise under variable lease payment provisions and, because of the close association of the indemnification payments to specific aspects of the tax law, any payments should be accounted for in a manner that recognizes the tax law association. The lease classification should not be changed.

## 4.5 INITIAL DIRECT COSTS



### FASB REFERENCES

ASC 842-10-20 Glossary

#### Initial Direct Costs

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

Initial direct costs include, for example, commissions and payments made to an existing tenant to incentivize that tenant to terminate its lease.

Costs to prepare a lease that would have been incurred regardless of whether the lease was obtained are not considered initial direct costs and therefore should be expensed as incurred. Those include:

- ▶ Fixed employee salaries (e.g., allocation of employee costs for time negotiating lease terms and conditions),
- ▶ General overheads such as depreciation, occupancy and equipment costs, unsuccessful origination efforts, and idle time,
- ▶ Costs for advertising and similar activities, and
- ▶ Other costs related to activities that occur before a lease is obtained, such as external legal and tax fees, costs of evaluating a prospective lessee's financial condition, travel costs related to the lease proposal.

The guidance in ASC 842 about initial direct costs represents a significant change from ASC 840 and is aligned with the definition of costs to acquire a contract under ASC 606. See Example 27 in ASC 842-10-55 for an illustration of the determination of initial direct costs for a lessee and a lessor.

A lessee allocates initial direct costs to the separate lease components on the same basis as the lease payments. A lessor allocates any capitalized costs (for example, initial direct costs or contract costs capitalized under ASC 340-40 on other assets and deferred costs) to the separate lease components or nonlease components to which those costs relate.

## 4.6 DISCOUNT RATE

### 4.6.1 Definitions

|   | DISCOUNT RATE FOR THE LEASE   | RATE IMPLICIT IN THE LEASE   | INCREMENTAL BORROWING RATE  |
|---|---|--|---|
|  ASC 842 | <p>For a lessee, the discount rate for the lease is the rate implicit in the lease unless that rate cannot be readily determined. In that case, the lessee is required to use its incremental borrowing rate.</p> <p>For a lessor, the discount rate for the lease is the rate implicit in the lease.</p> | <p>The rate of interest that, at a given date, causes the aggregate present value of: (a) the lease payments, and (b) the amount that a lessor expects to derive from the underlying asset following the end of the lease term, to equal the sum of: (1) the fair value of the underlying asset minus any related investment tax credit retained and expected to be realized by the lessor, and (2) any deferred initial direct costs of the lessor.</p> <p>However, if the rate determined in accordance with the preceding sentence is less than zero, a rate implicit in the lease of zero shall be used.</p> | <p>The rate of interest that a lessee would have to pay to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment.</p> <p>A lessee that is not a public business entity is permitted to use a risk-free discount rate for the lease, determined using a period comparable with that of the lease term, as an accounting policy election (see Section 4.6.3 for additional details).</p> |
|        | <p><i>Except for certain leases (for example, some related party leases), a lessee typically cannot readily determine the rate implicit in the lease because it does not have all required inputs. Accordingly, a lessee will typically use its incremental borrowing rate.</i></p>                       | <p><i>How the rate is calculated as it relates to initial direct costs will depend on the lease classification test performed (see Lease Classification section below for additional details).</i></p> <p><i>If the residual value of the underlying asset is expected to increase over the lease term (e.g., land), we believe a lessor should use the fair value at the commencement date in determining the rate implicit in the lease.</i></p>   | <p><i>A risk-free rate is typically lower than a collateralized rate and as such, will result in a higher right-of-use asset and lease liability for lessees. It could also result in a different classification of the lease.</i></p>  |

#### 4.6.2 Incremental Borrowing Rate

| ASC 842 | WHAT THE STANDARD SAYS...   | WHAT IT MEANS...  |
|---------|---|---|
|         | The rate of interest that a lessee would have to pay to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment. | The rate should be based on the credit standing of the lessee (which may also be the credit standing of the parent entity - see further discussion below). It is a secured (recourse) rate that is fully collateralized (i.e., it cannot be under-collateralized). The lessee is not limited to the underlying asset (i.e., other collateral may work if accepted by a lender) although the lessee should consider the nature and quality (liquidity) of the collateral used. ASC 842 does not explicitly refer to the "lease term". We believe a lessee may use either the lease term or consider the lease term plus options not reasonably certain of exercise, as an accounting policy - see observation below for additional details. Payments are determined based on ASC 842's definition of lease payments in paragraph 842-10-30-5. Accordingly, variable payments other than those based on an index or a rate are not considered. See Lease Payments section above for additional discussion on lease payments. It should reflect a rate that would be paid by the entity on borrowings that are entered into at or near the same time, in the same or similar jurisdiction, and in the same currency. |

In determining the incremental borrowing rate, a lessee may find the following useful:

- ▶ A lessee may consider its existing debt arrangements and whether those can be used to derive the incremental borrowing rate, with appropriate adjustments to materially comply with the definition of the incremental borrowing rate as described above (for example, adjusted to reflect a similar term as the lease, etc.). If a lessee borrows on an unsecured basis only, the entity may still use that rate as a starting point with further appropriate adjustments.
- ▶ A lessee with little or no debt may use published reference rates such as government rates as a starting point, and adjust those rates for the lessee's credit risk, financing term, and quality of collateral, etc.
- ▶ A lessee with a high volume of leases may consider constructing a synthetic corporate yield curve in which it considers an appropriate risk-free rate and a credit spread (whether based on its public credit rating or implied credit rating). Further adjustments would be made, for example, for the collateral, for which the lessee may use a "notching approach" or a "recovery rate approach" to reflect a secured rate. A lessee using yield curves to determine its incremental borrowing rate should develop processes and controls to periodically review and update the assumptions used in the development of the yield curve. For example, a lessee could develop a process to periodically pull market data and compare that market data to the inputs used in the yield curve to monitor for changes, and establish appropriate thresholds for determining whether/when to update the inputs of the yield curve. A lessee would also need to periodically monitor for changes in its credit profile (i.e., enhancements or deterioration in credit profile).
- ▶ A lessee may use a portfolio approach when determining the incremental borrowing rate of multiple leases when the leases have similar characteristics, such as a similar lease term, similar lease payments, and similar economic environment, as illustrated in Example 2 of ASC 842-20-55. A single discount rate applied to all leases in a portfolio should not result in a materially different answer than using a discount rate determined for each lease.

We also believe that the determination of the incremental borrowing rate should be consistent with the pattern of lease payments and how such payments are reflected in the measurement of the lease liability, which generally should result in the use of a rate that reflects an amortizing loan.

The following rates typically cannot be used as the incremental borrowing rate:

- ▶ Weighted-average cost of capital,
- ▶ Property yields,
- ▶ Cost of money,
- ▶ Blended rate (e.g., mix of secured and unsecured rate) as it may have been used under ASC 840.

#### BDO INSIGHTS – A RATE DETERMINED OVER A SIMILAR TERM

ASC 842 notes that the incremental borrowing rate is the rate of interest that a lessee would have to pay to borrow on a collateralized basis over a **similar term** an amount equal to the lease payments in a similar economic environment. However, questions may arise as to whether “similar term” is intended to mean the “lease term”, as defined in ASC 842.

When the lease includes options (such as a lessee extension option) and those are not reasonably certain of exercise at the commencement date, we believe a lessee may use either (a) the lease term as defined in ASC 842 and described in paragraph 842-10-30-1, or (b) a rate that reflects the existence of the option(s). This is consistent with the guidance in paragraph 842-20-35-5(a) on subsequent remeasurement of the lease liability which indicates that the discount rate does not have to be updated for a change in lease term or assessment of a purchase option if the rate already reflects that the lessee had such option. We believe that this is a policy election that should be applied consistently to all leases.

However, if a lessee that is not a public business entity elects to use the risk-free discount rate (see Section 4.6.3), it should use the lease term only. This is because paragraph 842-20-30-3 explicitly notes that the risk-free rate is determined over a period comparable with that of the lease term.

#### BDO INSIGHTS – USE OF PARENT VERSUS SUBSIDIARY RATE

Paragraph BC201 of ASU 2016-02 discusses that in some situations, it may be reasonable for a subsidiary to use a parent entity’s incremental borrowing rate. The example given is when the subsidiary does not have its own treasury function and the parent entity provided a guarantee of the lease payments. In concluding on that example, the FASB noted that pricing of the lease was more significantly influenced by the credit standing of the parent than the subsidiary. Example 2 in Subtopic 842-20-55 also illustrates the use of a parent’s incremental borrowing rate because pricing of the lease was influenced by the parent’s credit standing although the parent entity did not provide a guarantee in that example.

A lessee subsidiary should consider its specific facts and circumstances in determining whether it can use the parent rate or is required to use its own (subsidiary) rate. We believe a lessee subsidiary may use its parent rate in situations in which pricing of the lease was more significantly influenced by the credit standing of the parent than that of the subsidiary (for example, when the lessee subsidiary does not have its own treasury function and the parent entity was involved in negotiations for the lease).

#### 4.6.3 Discount Rate for Lessees That Are Not Public Business Entities

The FASB initially provided lessees that are not public business entities with an accounting policy to use a risk-free discount rate applicable for all leases. The discount rate is an important input in the accounting for a lease as it may impact lease classification and it directly affects the amounts of leases recognized on the balance sheet and the amounts of interest and amortization expense reported for finance leases. However, because the practical expedient had to be elected for all leases, some private companies were reluctant to elect it based on those financial statement impacts resulting from the current economic environment in which the risk-free rate is very low.

The FASB issued ASU 2021-09 in November 2021 which now permits lessees to make the risk-free rate election by asset class rather than for all leases. Accordingly, a lessee now has more flexibility in electing the risk-free rate accounting policy. For example, a lessee may elect to use the risk-free discount rate for asset classes that have lower values and/or greater volumes of leases (e.g., some office equipment leases), while using their incremental borrowing rate for more material asset classes (such as real estate). Some Board members and FASB staff observed at the September 15, 2021 public meeting that there is no prescribed requirements for determining asset classes, and that therefore a lessee has flexibility in identifying its asset classes for purposes of applying ASC 842.

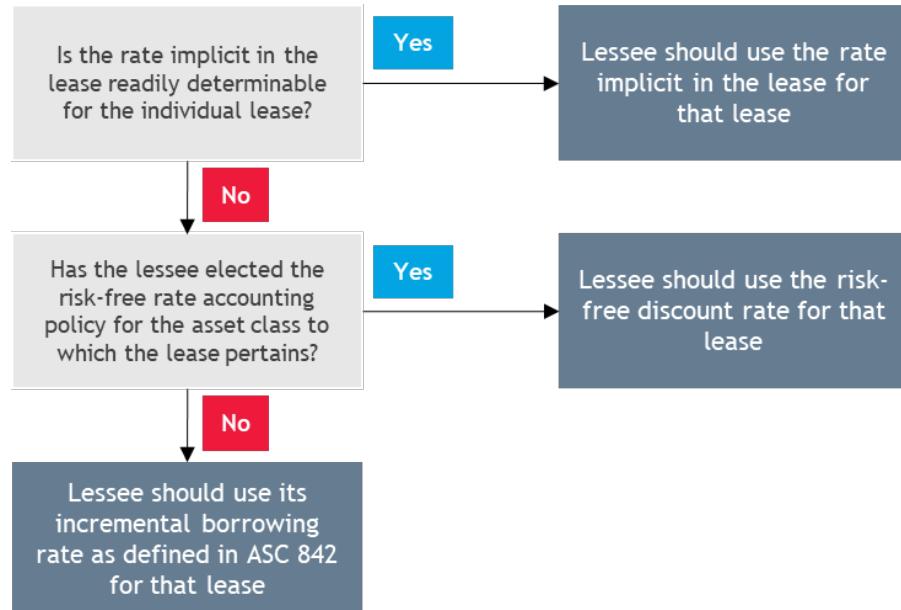
The accounting policy is limited to entities that are not public business entities. Because not-for-profit entities (including conduit bond obligors) and employee benefit plans are not *public business entities* (according to the definition in the Master Glossary), they are permitted to make the risk-free discount rate election. A lessee that elects the practical expedient should disclose that fact and the asset classes for which it has elected it.



#### RISK FREE RATE ELECTION DOES NOT APPLY TO ALL LEASES

In considering changes to the risk-free rate election, the FASB learned that the interaction between a lessee's requirement to use the rate implicit in the lease when readily determinable and the lessee's application of the risk-free rate election was unclear under ASC 842 because the risk-free rate election initially applied to all leases. The FASB therefore decided to clarify that a lessee should use the rate implicit in the lease when it is readily determinable, even if the lessee elects the risk-free rate election. While the rate implicit in the lease is typically not readily determinable, it may be in certain leases (for example, common control leases).

The following flowchart summarizes a lessee's decision steps in determining the discount rate for the lease for a lessee that is not a public business entity:



## 4.7 ECONOMIC LIFE

ASC 842 defines economic life as “[e]ither the period over which an asset is expected to be economically usable by one or more users or the number of production or similar units expected to be obtained from an asset by one or more users.”

We believe this definition is largely consistent with the prior definition of economic life in ASC 840 for lease classification purposes and therefore should lead to similar determinations of economic life.

## 4.8 FAIR VALUE

ASC 842 defines fair value as “[t]he 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.”

This is the same definition of fair value used in ASC 820 on fair value measurement. As a result, an entity should apply the guidance in ASC 820 when determining the fair value of an underlying asset.

However, for lessors that are not a manufacturer or dealer (i.e., generally financial institutions and captive finance companies), the fair value of the underlying asset at lease commencement is defined as its cost, reflecting any volume or trade discounts that apply. This exception applies only if there has not been a significant lapse of time between the acquisition of the underlying asset and lease commencement. If there has been a significant lapse of time, the lessor must apply the ASC 820 definition of fair value. This fair value exception is consistent with the fair value exception that existed under ASC 840, which the FASB added to ASC 842 with the issuance of ASU 2019-01 following feedback from lessors previously qualifying for the exception in ASC 840.

### BDO INSIGHTS – DETERMINING FAIR VALUE WITHOUT UNDUE COSTS AND EFFORTS

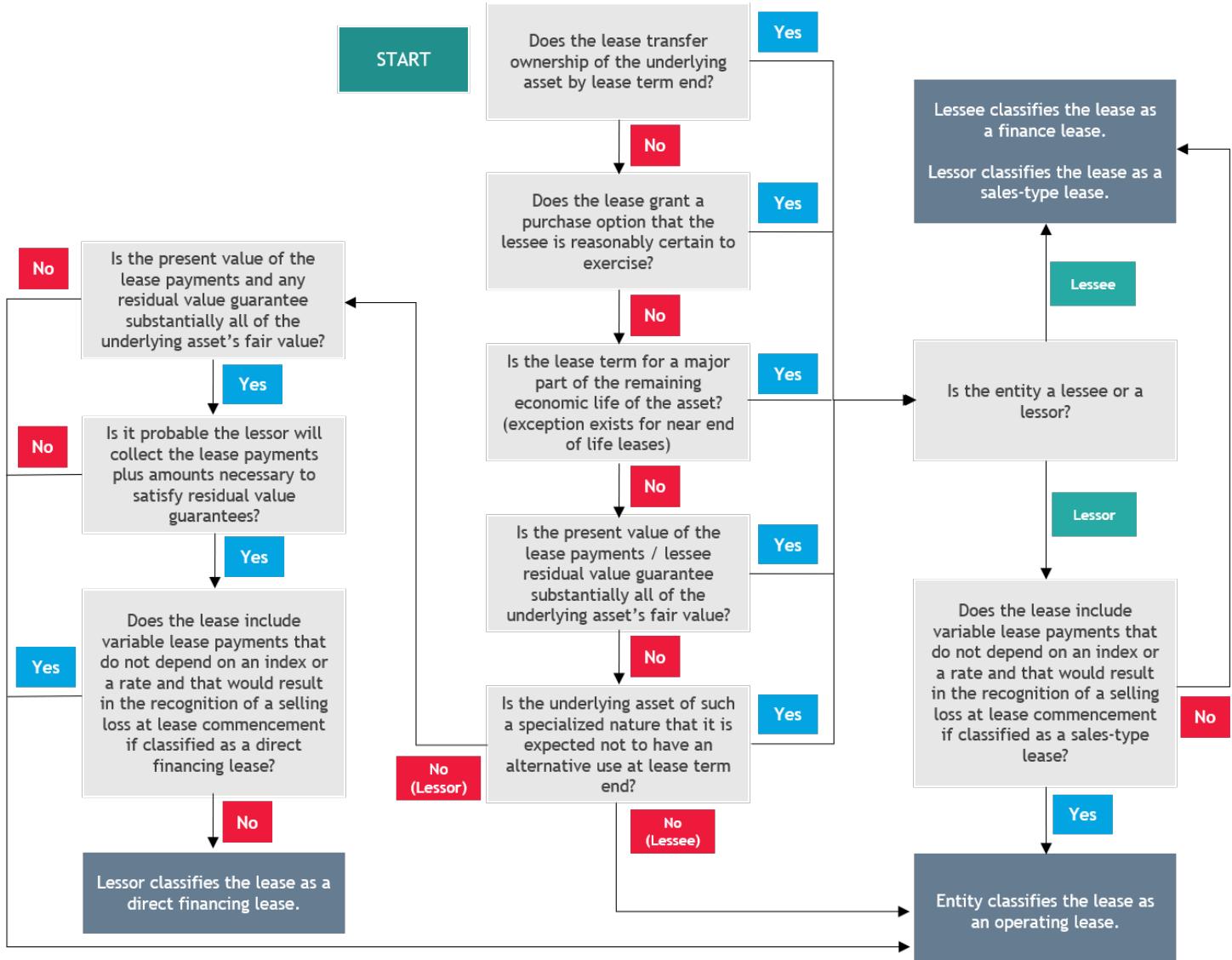
Paragraph 842-10-55-3 notes that in some cases, it may not be practicable for an entity to determine the fair value of an underlying asset, meaning that a reasonable estimate cannot be made without undue cost or effort. That paragraph also notes that if it is not practicable for an entity to determine the fair value of an underlying asset, lease classification should be determined without consideration of the present value classification criteria (i.e., paragraphs 842-10-25-2(d) and 842-10-25-3(b)(1) which we discuss further below in the Lease Classification section).

We believe fair value can be determined without undue cost or effort in most cases. However, an entity is not *always* required to obtain an appraisal or similar valuation. Instead, in many cases an entity may be able to make a reasonable estimate of fair value. For example, for the lease of one floor of a building, it may be appropriate to determine fair value of the portion leased by taking the fair value of the building as a whole and applying an appropriate percentage based on floors leased to total number of floors, or square feet leased to total square feet of the building if more representative of the space used, with appropriate adjustments as needed (for example, if a market participant would ascribe more value to higher floors in the building). However, a more precise estimate of fair value generally should be made (and appraisal or similar valuation may need to be obtained) if it is likely that lease classification could change, and such change in classification would be significant to the financial statements.

One exception is for leases of spaces owned by a governmental unit or authority. For leases involving terminal space and other airport facilities, ports and bus terminals and similar spaces owned by a governmental unit or authority, it may not be practicable to determine the fair value of the underlying asset. In those situations, paragraph 842-10-55-13 notes that such leases are classified as operating leases if they do not provide for a transfer of ownership or a lessee purchase option that is reasonably certain of exercise. However, certain conditions must be met to apply that guidance as outlined in paragraph 842-10-55-13.

## 4.9 LEASE CLASSIFICATION

Once an entity has obtained all relevant inputs described above, it can perform the lease classification assessment. Lease classification is determined at the commencement date of the lease. The analysis is summarized in the following flowchart based on paragraphs 842-10-25-2 through 25-3A.



The following table provides additional guidance on the lease classification analysis described in the above graph:

| STEP                            | ADDITIONAL GUIDANCE   |
|---------------------------------|---|
| Transfer of ownership criterion | <ul style="list-style-type: none"> <li>▶ This criterion is met in leases that provide that the lessor execute and deliver to the lessee such documents (including, if applicable, a bill of sale) as may be required to release the underlying asset from the lease and to transfer ownership to the lessee, upon the lessee's performance in accordance with the terms of the lease.</li> <li>▶ This criterion is also met when the lease <b>requires</b> the payment by the lessee of a nominal amount (e.g., minimum fee required by statutory regulation to transfer ownership) in connection with the transfer of ownership.</li> <li>▶ But if the lease transfers ownership of the asset if the lessee <b>elects</b> to pay a specified fee (whether nominal or otherwise) to complete the transfer, it does not satisfy the transfer-of-ownership criterion. Instead, an entity assesses it as an option to purchase the underlying asset (see below).</li> </ul>  |
| Purchase option criterion       | <ul style="list-style-type: none"> <li>▶ If a lessee is reasonably certain to exercise a purchase option, the exercise price of the option is included in the lease payments and the lease is classified as a finance lease by the lessee and a sales-type lease by the lessor (unless there are variable lease payments not based on an index or a rate and it would result in a selling loss). See Lease Payments section for a discussion of the assessment of purchase options.</li> </ul>  |
| Lease term criterion            | <ul style="list-style-type: none"> <li>▶ One reasonable approach to assess this criterion is that 75% or more of the remaining economic life of the asset represents a major part of the asset's remaining economic life, and that a commencement date that falls within the last 25% of the total economic life of the underlying asset results in a commencement date that falls at or near the end of the asset's economic life.</li> <li>▶ If the lease contract includes the right to use multiple underlying assets that represent a single lease component under paragraphs 842-10-15-28 and 15-29 (see Chapter 3), use the remaining economic life of the predominant asset.</li> </ul>   |
| Present value criteria          | <ul style="list-style-type: none"> <li>▶ One reasonable approach to assess these criteria is that 90% or more of the asset's fair value amounts to substantially all.</li> <li>▶ Any related investment tax credit retained by the lessor and expected to be realized by the lessor reduces the fair value of the underlying asset.</li> <li>▶ Fees paid by a lessee to owners of a special purpose entity for structuring the transaction, while included in lease payments, are not included in the fair value of the underlying asset when assessing the sales-type lease present value criterion.</li> <li>▶ For a lessor only, for the sales-type lease present value criterion the rate implicit in the lease should exclude any initial direct costs if the fair value of the underlying asset differs from its carrying amount. For assessing the direct-financing lease present value criterion, initial direct costs are included in all cases. We illustrate this further in Chapter 6 on lessor accounting.</li> <li>▶ Residual value guarantees of a portfolio of underlying assets (for which settlement is not solely based on the residual value of the individual underlying assets, and for which excess is offset against shortfalls in residual value that exist in other assets in the portfolio) preclude a lessor from determining the amount of the guaranteed residual value of any individual underlying asset within the portfolio and, therefore, no such amounts should be considered by the lessor when evaluating these criteria.</li> </ul> |

| STEP                                | ADDITIONAL GUIDANCE ( <i>CONTINUED</i> )   |
|-------------------------------------|--|
| Alternative Use Criterion           | <ul style="list-style-type: none"> <li>▶ In assessing this criterion, an entity considers the effects of (1) contractual restrictions and (2) practical limitations on the lessor's ability to readily direct that asset for another use (e.g., selling it or leasing it to an entity other than the lessee).</li> <li>▶ A contractual restriction on a lessor's ability to direct an underlying asset for another use must be substantive for the asset not to have an alternative use to the lessor. A contractual restriction is substantive if it is enforceable.</li> <li>▶ A practical limitation on a lessor's ability to direct an underlying asset for another use exists if the lessor would incur significant economic losses to direct the underlying asset for another use, such as 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. Examples include when the underlying asset has design specifications unique to the lessee or the asset is in a remote area.</li> <li>▶ The possibility of the contract with the customer being terminated does not affect the assessment of this criterion.</li> </ul> |
| Probability of Collection Criterion | <ul style="list-style-type: none"> <li>▶ The question of collectibility is no longer relevant for determining whether a lease is classified as a sales-type lease, which is a change from prior GAAP. However, the collectibility assessment is still relevant for determining whether a lease is classified as a direct-financing lease. If collection is not probable, the lease is classified as an operating lease by the lessor.</li> </ul>   |

The following guidance is also important for specific transactions or provisions in lease contracts:

| TRANSACTION   | ADDITIONAL GUIDANCE   |
|---|---|
| Business combinations or acquisition by not-for-profit entity | <ul style="list-style-type: none"> <li>▶ The acquiring entity should retain the previous lease classification unless there is a lease modification that is not accounted for as a separate contract.</li> <li>▶ For asset acquisitions, refer to Chapter 7 on other topics.</li> </ul>  |
| Related party leases  | <ul style="list-style-type: none"> <li>▶ Except for common control leases, related party leases are classified based on the classification criteria applicable to all other leases using the legally enforceable terms and conditions of the lease. In doing so, an entity may need to consider whether provisions beyond those included in the written contract are legally enforceable, which may require judgment and sometimes input from legal counsel. In the separate financial statements of the related parties, the classification and accounting for the leases should be the same as for leases between unrelated parties.</li> <li>▶ For common control leases, see Section 2.5 for further discussion.</li> <li>▶ The legally enforceable terms and conditions (or the written terms and conditions, if the practical expedient discussed in Section 2.5 for common control arrangements is elected) should be utilized even if they are not consistent with rates or terms that would be required in a transaction between unrelated market participants.</li> </ul> |
| Lessee indemnification for environmental contamination        | <ul style="list-style-type: none"> <li>▶ A provision that requires lessee indemnification for environmental contamination, whether for environmental contamination caused by the lessee during its use of the underlying asset over the lease term or for preexisting environmental contamination, should not affect lease classification. Those indemnifications are accounted for under other GAAP (ASC 410-20 or ASC 460-10 depending on the indemnification).</li> </ul>  |

**BDO INSIGHTS – CLASSIFICATION WITH REMOVAL OF THE LEGACY “BRIGHT LINES”**

The lease classification tests in paragraphs 842-10-25-2 and 25-3 do not refer to bright-line thresholds as previously required under ASC 840. Instead, those bright lines were replaced with terminologies such as “major part” when discussing the lease term criterion, or “substantially all” when discussing the present value criteria. When determining how to apply this guidance, paragraph 842-10-55-2 permits the continued use of those bright lines. This was provided to assist companies in establishing internal accounting policies and controls and in applying the requirements in an operational and scalable manner. While application of those bright lines is not required, if an entity deviates from those bright lines, it should consider how best to articulate accounting policies in order to achieve consistent classification for similar leases, while adhering to the economic structure of the arrangement and the lease classification principles in ASC 842. While companies could adopt a policy that establishes ranges, like the approach taken when determining whether a contingent liability is probable under ASC 450-20, entities should also consider how those terms are applied in other areas of GAAP and ensure consistent application. For example, “substantially all” is used in many other areas of GAAP and is understood to generally be at or around 90%. A reporting entity should document its definition of “substantially all” and “major part.” Deviating from the use of the bright lines allowed by paragraph 842-10-55-2 will require an entity to document its considerations in arriving at the thresholds used, and to demonstrate that the use of such thresholds is appropriate.

**BDO INSIGHTS – ALTERNATIVE USE TEST**

ASC 842 added a classification criterion on whether a lease is a finance lease for a lessee or a sales-type lease for a lessor that did not exist under ASC 840; specifically, whether 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. We expect that for leases of this nature, most lessors would structure such contracts to ensure that they recover their investment in the underlying asset through the required lease payments, and that therefore the present value of the lease payments would represent substantially all of the fair value of the underlying asset, thereby meeting at least one other lease classification criterion. However, this may not always be the case, such as when a significant portion of the payments are variable. Even so, an inability by the lessor to repurpose the asset without undue cost at the end of the lease term will result in finance/sales-type lease treatment for the lessee and for the lessor (unless there are variable lease payments not based on an index or a rate and it would result in a selling loss), respectively.

**EXAMPLE 5 - ALTERNATIVE USE CRITERION MET****FACTS**

- ▶ Widget Co. enters into a lease agreement with Bob’s Custom Manufacturing.
- ▶ Under the agreement, Bob’s will construct a piece of equipment to be used in Widget’s production process.
- ▶ The requirements for the asset will be provided by Widget and are subject to a U.S. patented design.
- ▶ It would also be cost prohibitive for Bob’s to modify the equipment in such a way that it no longer complies with the patented design requirements.

**WHAT IS THE CLASSIFICATION OF THE LEASE?**

- ▶ Because of the existence of the patent, Bob’s would be precluded from reusing the equipment at the end of the lease through redirecting it through a sale or subsequent lease.
- ▶ The alternative use criterion is met. Widget Co. should account for the lease as a finance lease, and Bob’s should account for the lease as a sales-type lease (unless there are variable lease payments not based on an index or a rate and it would result in a selling loss).



# CHAPTER 5 – ACCOUNTING FOR LEASES – LESSEES



## 5.1 OVERVIEW

We discussed in Chapter 4 important concepts such as the commencement date, lease term, lease payments, discount rate, and so forth, and how an entity classifies a lease. Once the entity has determined all those relevant inputs, it can recognize and measure the lease on balance sheet at the commencement date.

Users of financial statements indicated that previous lease accounting guidance did not provide sufficient useful information with regards to an entity's leasing activities because most leases (that is, operating leases) were not recognized on the balance sheet. As a result, users often adjusted lessees' financial statements to capitalize operating leases to better reflect lessees' leverage and exposure to credit risk, but different estimation approaches and limited information available created information asymmetry in the market, and adjustments varied significantly based on different assumptions.

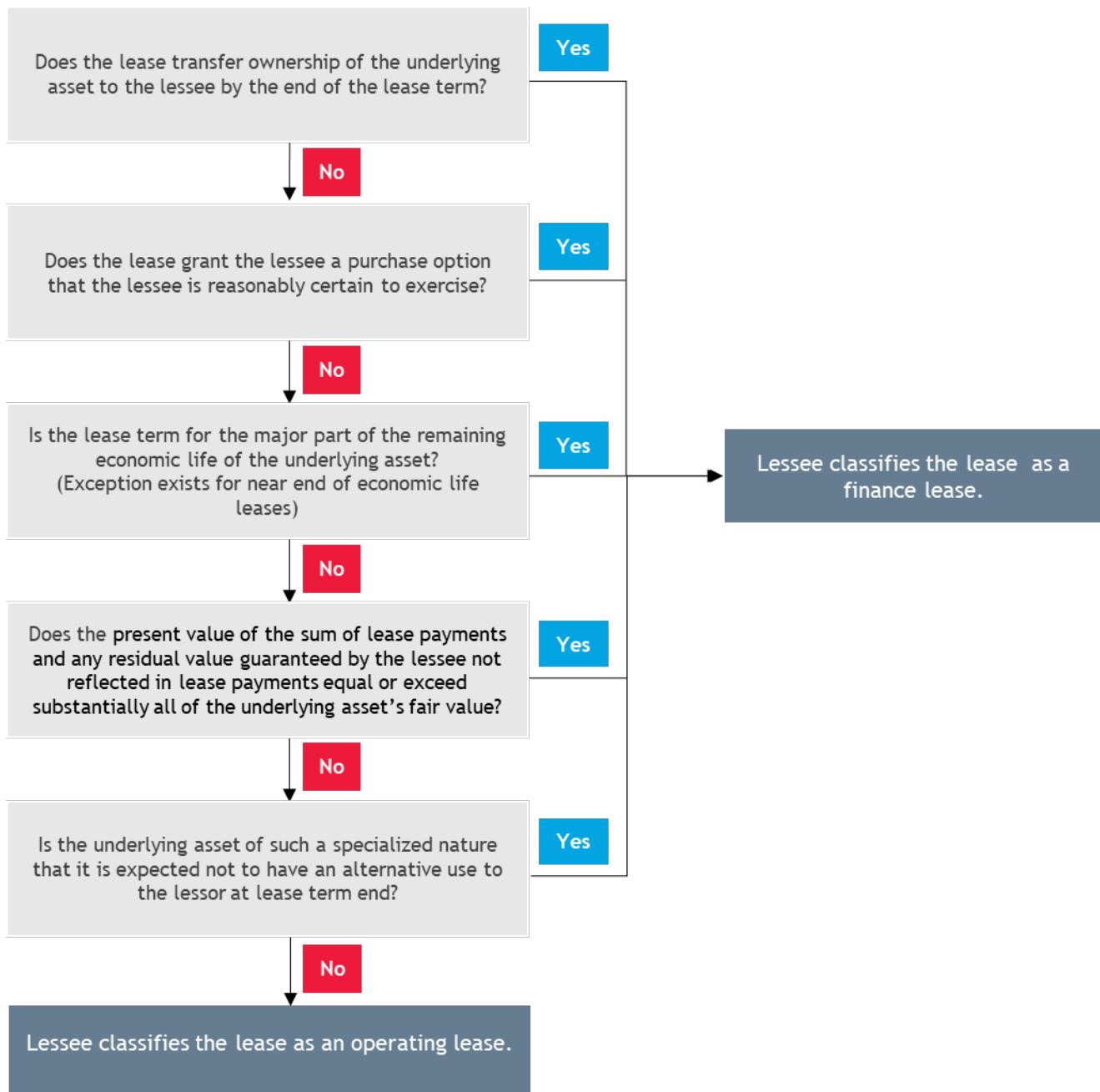
ASC 842 is intended to address those issues because most leases (whether operating or finance) are now recognized on balance sheet at the commencement date unless the practical expedient for short-term leases is elected (see below). The new model reflects that at the commencement date of a lease, a lessee has a financial obligation to make lease payments to the lessor in exchange for its right to use the underlying asset, and accordingly it should recognize a right-of-use (ROU) asset and a lease liability for these rights and obligations.

The lessee accounting model in ASC 842 still retains the distinction between operating and finance leases because the FASB viewed economic differences among those leases. Specifically, the FASB determined that finance leases are generally economically similar to purchased PP&E because the lessee essentially obtains control of the underlying asset rather than merely obtaining control over the use of the underlying asset for the lease term. In contrast, in an operating lease the lessee does not obtain substantially all of the remaining benefits from the underlying asset; frequently, the lessee obtains only a minor portion of the remaining benefits and will not be exposed to or benefit from any changes in the underlying asset's value during the lease term.

The FASB also provided lessees with a practical expedient not to recognize short-term leases on balance sheet. A short-term lease is a lease with a lease term of 12 months or less and that does not include a lessee purchase option that is reasonably certain of exercise. This election is by asset class and, if elected, a lessee recognizes lease payments on a straight-line basis over the lease term along with variable lease payments when incurred, consistent with ASC 840.

## 5.2 LEASE CLASSIFICATION BY LESSEES

As a reminder, the following flowchart summarizes a lessee's classification of a lease under ASC 842, which we discussed in further details in Chapter 4.



## 5.3 SUMMARY ACCOUNTING REQUIREMENTS BASED ON LEASE CLASSIFICATION

|                  | FINANCE LEASES   |   | OPERATING LEASES  |   |
|------------------|--|---|---|---|
|                  | ROU ASSET  | LEASE LIABILITY   | ROU ASSET   | LEASE LIABILITY   |
| Balance Sheet    | ROU asset is initially measured at the amount of the lease liability, plus initial direct costs and prepaid lease payments, less lease incentives received.  | Lease liability is initially measured at the present value of the unpaid lease payments.  | Initial measurement is the same as for finance leases.  |   |
|                  | Subsequently, ROU asset is typically amortized on a straight-line basis to the earlier of the end of its useful life or lease term. <sup>10</sup>  | Subsequently, lease liability is increased to reflect interest using the interest method and decreased for lease payments made. | Amortize based on difference between periodic straight-line lease cost (incl. amortization of initial direct costs) and periodic interest accretion.  | Subsequent measurement is the same as for finance leases. |
| Income Statement | <ul style="list-style-type: none"> <li>▶ Recognize amortization of ROU asset,</li> <li>▶ Recognize interest on lease liability,</li> <li>▶ Recognize variable lease payments not included in the lease liability when incurred, and</li> <li>▶ Recognize an impairment loss if the ROU asset is impaired under ASC 360.</li> </ul> |   | <ul style="list-style-type: none"> <li>▶ Recognize a single lease cost generally on a straight-line basis,</li> <li>▶ Recognize variable lease payments not included in the lease liability when incurred, and</li> <li>▶ Recognize an impairment loss if the ROU asset is impaired under ASC 360. Also, after an impairment, recognition of lease cost is no longer on a straight-line basis (but still recognized as a single lease cost).</li> </ul> |   |

Also, note the following:

- ▶ ASC 842 considers the right to control the use of the underlying asset as the equivalent of physical use. That is, recognition of lease cost under the operating lease model, or amortization of the right-of-use asset for finance leases, should not be affected by the extent to which the lessee uses the underlying asset, and therefore typically is on a straight-line basis.
- ▶ The right-of-use asset is a nonmonetary asset while the lease liability is a monetary liability. Therefore, when accounting for a lease denominated in a foreign currency, if remeasurement into the lessee's functional currency is required, the lease liability is remeasured using the current exchange rate, while the right-of-use asset is remeasured using the exchange rate as of the commencement date.
- ▶ Once recognized on balance sheet, ASC 842 also includes requirements for lessees to update the measurement of leases for certain lease modifications and other reassessment events. Lessees will need robust processes and controls to timely and completely identify and account for such events.
- ▶ The accounting in the table above may not apply to certain leases entered into for R&D activities. See Section 5.5.2.2 for further discussion.

<sup>10</sup> However, if the lease transfers ownership of the underlying asset to the lessee or the lessee is reasonably certain to exercise an option to purchase the underlying asset, the lessee amortizes the right-of-use asset to the end of the useful life of the underlying asset.

## 5.4 SHORT-TERM LEASES

ASC 842 defines a short-term lease as:



### FASB REFERENCES

#### ASC 842-10-20

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.

ASC 842 provides lessees with a practical expedient related to short-term leases under which the ASC 842 balance sheet recognition provisions are not applied to these leases. This election is made by class of underlying asset to which the right of use relates (e.g. office equipment, real estate, vehicles). If elected, leases that qualify for the exemption are not recognized on balance sheet and lease payments are recognized on a straight-line basis over the lease term, consistent with legacy guidance for operating leases. Variable lease payments are also recognized in the period in which the obligation for those payments is incurred.

If the lease term or the assessment of a lessee purchase option changes such that, after the change, the remaining lease term extends more than 12 months from the end of the previously determined lease term or the lessee is reasonably certain to exercise its purchase option, the lease no longer meets the definition of a short-term lease and the lessee should apply the general guidance, including balance sheet recognition, as if the date of the change in circumstances is the commencement date of the lease.

This practical expedient was provided to simplify the accounting for such short-term leases. However, a lessee still must apply the ASC 842 requirements related to initial assessment of the lease term and lessee purchase options, including whether the lessee is reasonably certain to exercise an extension or purchase option. This also means that short-term leases are subject to the lease term and purchase option reassessment requirements in ASC 842. Short-term leases also are subject to specific disclosure requirements. Accordingly, even with the practical expedient, short-term leases are not scoped out of ASC 842 entirely.

In deliberating whether to include the short-term lease exception, the FASB considered the risk that entities may wish to structure a lease in order to obtain short-term lease accounting; for example, by setting a noncancelable lease period which is shorter than 12 months while incorporating a series of one-year renewal options, or by entering into a longer-term lease that includes a series of termination options. However, the FASB noted in paragraph BC381 of ASU 2016-02 “that there are significant economic disincentives to both parties to entering into a series of short-term leases in place of longer-term leases such that there is not a significant structuring risk throughout the system. For example, lessees may have to pay a premium rental price to compensate the lessor for its increased residual asset risk, and some lessors will be unable to enter into short-term leases depending on the terms of the financing they obtained to acquire the underlying asset.”

**EXAMPLE 1 - LEASE IS A SHORT-TERM LEASE****FACTS**

- ▶ Dom Co. is an auto leasing company.
- ▶ Lessee enters into a lease with Dom Co. for the use of 20 cars for use by its sales force.
- ▶ The stated term of the lease is 12 months, with the lessee having the right to renew the lease for an additional 12 months.
- ▶ The monthly lease payments during the renewal period are the same as the monthly payments in the initial period.
- ▶ There are no purchase options.
- ▶ The cars are not specialized, and alternative cars are available in the market at similar lease rates.
- ▶ Lessee has made an accounting policy election not to recognize right-of-use assets and lease liabilities arising from short-term leases for any class of underlying asset.

**ANALYSIS**

- ▶ Lessee considered all relevant factors at the commencement date and determined that it is not reasonably certain to exercise the renewal option.

**CONCLUSION**

- ▶ The lease meets the definition of a short-term lease because the lease term is 12 months or less, there are no purchase options, and it is not reasonably certain that Lessee will exercise the renewal option.
- ▶ Lessee does not recognize the right-of-use asset and lease liability arising from the lease. Rather, the lease payments are recognized on a straight-line basis over one year.

**EXAMPLE 2 - LEASE IS NOT A SHORT-TERM LEASE - TERMINATION OPTIONS****FACTS**

- ▶ Ironside Co. manufactures heavy machinery for construction.
- ▶ Lessee enters into a lease with Ironside Co. for the use of two cranes.
- ▶ The stated term of the lease is 3 years, with the lessee having the right to terminate it at any time after one year.
- ▶ The contract specifies an early termination penalty equal to 15% of the total lease payments.
- ▶ Lessee has made an accounting policy election not to recognize right-of-use assets and lease liabilities that arise from short-term leases for any class of underlying asset.

**ANALYSIS**

- ▶ Lessee concludes that due to the significant termination penalty and other factors it is reasonably certain not to exercise the termination option.

**CONCLUSION**

- ▶ Lessee concludes that the lease term is 3 years. Therefore, the lease does not qualify for the short-term lease exception.
- ▶ Accordingly, Lessee applies the general requirements in ASC 842 to this lease, including recognizing a right-of-use asset and lease liability.

**EXAMPLE 3 - LEASE IS A SHORT-TERM LEASE - RENEWAL OPTIONS****FACTS**

- ▶ Assume the same facts as in Example 2 apply, in which Lessee entered into a lease with Ironside Co. for the use of two cranes, except that the contract does not specify a stated term.
- ▶ Instead, the cranes are subject to a daily rental rate, and the lease can be renewed indefinitely.
- ▶ Lessee has made an accounting policy election not to recognize right-of-use assets and lease liabilities that arise from short-term leases for any class of underlying asset.

**ANALYSIS**

- ▶ Lessee analyzes the lease term considering all relevant factors at the commencement date. Lessee determines the most likely period of use based on expected need is six months and considers the physical difficulties of replacing a crane during that period with another crane with the same functionality along with the limited number of available cranes of this magnitude in the market.
- ▶ Consequently, Lessee determines that it is reasonably certain to exercise the renewal option for a period of six months.

**CONCLUSION**

- ▶ Lessee concludes that the lease term is six months and therefore the lease meets the definition of a short-term lease because the lease term is twelve months or less and there are no purchase options.
- ▶ Lessee does not recognize the right-of-use asset and lease liability arising from the lease. Rather, the lease payments are recognized on a straight-line basis over the 6-month period.

**EXAMPLE 4 - LEASE IS NOT A SHORT-TERM LEASE - PURCHASE OPTION****FACTS**

- ▶ Bellamy Inc. manufactures music instruments and related equipment.
- ▶ Lessee is a music band (assume it is a legal entity) that enters into a lease with Bellamy Inc. for the use of 3 guitars, 4 amplifiers, 2 loopers, and a drum set for the band's 3-month summer tour.
- ▶ The stated term of the lease is 3 months, with the Lessee having the right to purchase the equipment at a 15% discount at the end of the summer tour.
- ▶ Lessee has made an accounting policy election not to recognize right-of-use assets and lease liabilities that arise from short-term leases for any class of underlying asset.

**ANALYSIS**

- ▶ Lessee considers all relevant factors at the commencement date (including prevailing market prices for similar equipment and the lessee's need for the equipment in future gigs) and determines that it is reasonably certain to exercise the purchase option.

**CONCLUSION**

- ▶ Lessee concludes that the leases do not qualify for the short-term lease exception.
- ▶ Lessee applies the general requirements in ASC 842 to the leases, including recognizing a right-of-use asset and lease liability.

In some arrangements, the lease will not include a continuous and uninterrupted period of use, but rather will consist of non-consecutive periods of use. This can be due to the availability of the right-of-use asset to the lessee or the specific needs of the lessee. With regards to the definition of a lease, the Master Glossary defines *period of use* as:



## FASB REFERENCES

### ASC 842-10-20

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*). [Emphasis Added]

Therefore, the determination of whether a lease is a short-term lease is not performed based on each time increment separately, but rather based on the sum of the nonconsecutive periods for which the lessee uses the underlying asset.

### EXAMPLE 5 - LEASE IS NOT A SHORT-TERM LEASE - NON-CONSECUTIVE PERIODS

#### FACTS

- ▶ Lessee is a basketball association that wishes to host its playoffs in a large venue each season.
- ▶ Lessee enters into a lease with Ball-is-Life Co. for the use of 2 basketball arenas.
- ▶ Lessee has the right to use the arenas only during the months of May and June every year during a 10-year period.
- ▶ The lease contract does not include any options.
- ▶ Lessee has made an accounting policy election not to recognize right-of-use assets and lease liabilities that arise from short-term leases for any class of underlying asset.

#### ANALYSIS

- ▶ While each time increment (each playoff season) is shorter than 12 months (i.e., two months), Lessee determines that the lease term is 20 months (two months every year times ten years).

#### CONCLUSION

- ▶ Lessee concludes that the lease does not qualify for the short-term lease exception.
- ▶ Lessee applies the general requirements in ASC 842 to this lease, including recognizing a right-of-use asset and lease liability. Refer to Section 5.6.2 for a continuation of this example and illustration of subsequent accounting for this lease.

## 5.5 RECOGNITION AND INITIAL MEASUREMENT

### 5.5.1 Recognition

A lessee recognizes a right-of-use asset and a lease liability at the commencement date of the lease, which is the date on which the lessor makes the underlying asset available for use by the lessee. In some arrangements, the lessor may make the underlying asset available for use by the lessee before the lessee begins operations or makes lease payments. See Chapter 4 for additional details.

### 5.5.2 Initial Measurement

The initial measurement of the lease at the commencement date is the same for operating and financing leases.

A lessee initially measures the lease liability at the present value of the unpaid lease payments, discounted using the discount rate for the lease. The discount rate for the lease is calculated based on information available at the commencement date. A lessee uses the rate implicit in the lease whenever that rate is readily determinable, or otherwise uses its incremental borrowing rate. A lessee that is not a public business entity is permitted to use a risk-free discount rate for the lease, determined using a period comparable with that of the lease term, as an accounting policy election by asset class. See Chapter 4 for additional details.

The right-of-use asset is initially measured at cost as follows:



#### LESSEES MAY CAPITALIZE LESS AS INITIAL DIRECT COSTS

The definition of initial direct costs is substantially narrower under ASC 842 as compared to legacy guidance. This is due to the alignment with the concept of contract costs for revenue contracts (see ASC 340-40-25-1 through 25-3). That is, lessees may capitalize only incremental costs of a lease that would not have been incurred if the lease had not been obtained. Accordingly, many costs that were previously capitalized as a separate asset under operating leases (or as part of the leased asset for capital leases) are now required to be expensed when incurred.



#### ROU ASSET INITIAL MEASUREMENT NOT CAPPED AT UNDERLYING ASSET'S FAIR VALUE

Legacy guidance in ASC 840-30-30-3 capped the initial measurement of capital leases at the inception-date fair value of the leased property. However, ASC 842 did not carry forward that guidance and as such, the initial measurement of an ROU asset may exceed the underlying asset's fair value at the commencement date. In those situations, a lessee should first verify the assumptions used in measuring the lease (for example, incremental borrowing rate). If the assumptions are appropriate and the initial measurement of the ROU asset exceeds the underlying asset's fair value, the lessee should consider whether the ROU asset (or asset group to which the leased asset relates) is not recoverable (see Section 5.9 for further details).

### 5.5.2.1 Lessee Costs to Ready the Leased Asset for Its Intended Use

A lessee may incur costs to ready the leased asset for its intended use, such as shipping, installation and similar costs. If the lessee pays the lessor for those activities, the payments are either part of the consideration in the contract or are variable payments that do not depend on an index or a rate. However, the guidance is not clear when such costs are paid to a party other than the lessor or when the lessee incurs the costs itself. Costs for such activities are not initial direct costs because those are not costs to obtain a lease contract. Therefore, a lessee cannot capitalize such costs by applying the guidance on initial direct costs.

However, the SEC staff addressed this question.



#### SEC STAFF GUIDANCE

##### Remarks before the 2018 AICPA Conference on Current SEC and PCAOB Developments

Andrew W. Pidgeon, Professional Accounting Fellow, Office of the Chief Accountant

December 10, 2018

##### Certain lessee and lessor costs

In addition to transition questions, we have received application questions related to the new leases standard, including questions regarding lessee and lessor accounting for certain costs relating to a lease.

The first of those application questions related to lessee accounting for costs incurred to place a leased asset into use. For example, a lessee may pay a party other than the lessor to ship a leased asset to the lessee's premises. Topic 360 would require capitalization of those costs if the lessee purchased the asset.<sup>[9]</sup> Since the asset is leased, not purchased, the lessee could determine that the costs are in the scope of other GAAP,<sup>[10]</sup> or it could determine recognition in current period earnings is appropriate. In lieu of recognizing those costs in current period earnings, the staff did not object to a lessee, as an accounting policy election, analogizing to Topic 360 to capitalize costs incurred to place a leased asset into its intended use.

[...] I encourage lessees and lessors that elect to apply either of those accounting policies to apply the policies consistently and include appropriate disclosure of those policies if material.

[9] FASB ASC Topic No. 360, *Property, Plant, and Equipment* ("Topic 360"); specifically, ASC 360-10-30-1 states, in part, "... [t]hat the historical cost of acquiring an asset includes the costs necessarily incurred to bring it to the condition and location necessary for its intended use. ..."

[10] For example, costs incurred by a lessee could require deferral pursuant to FASB ASC Subtopic No. 340-40, *Other Assets and Deferred Costs - Contracts with Customers* ("Subtopic 340-40"), or capitalization pursuant to Topic 360, if the leased asset is used by the lessee to deliver goods or services to a customer, or to construct property for the lessee, respectively.

Accordingly, we believe that to the extent the costs are not in the scope of other GAAP, either of the following approaches is acceptable as an accounting policy election applied at the entity level and disclosed if material:

- ▶ Expense the costs as incurred, or
- ▶ Capitalize the costs by analogy to ASC 360 on property, plant or equipment for the costs incurred to bring the asset to the condition and location necessary for its intended use. In that situation, the costs capitalized under ASC 360 can either be recognized as a separate asset or as part of the ROU asset. Regardless of its choice, the amortization pattern of such costs should be the same and the lessee should include the assets in the same asset group for impairment testing purposes.

### 5.5.2.2 Leases Entered for R&D Activities

A lessee may enter into a lease for R&D activities where the ROU asset has no alternative future uses in other R&D projects or otherwise.<sup>11</sup>

In these scenarios, the accounting for the lease liability is unchanged (that is, it continues to represent an obligation that the lessee reports on its balance sheet). However, we believe the accounting for the ROU asset depends on lease classification.

| FINANCE LEASES   | OPERATING LEASES  |
|--|---|
| <p>Consistent with legacy guidance and as discussed in paragraph BC56 of ASU 2016-02, a finance lease under ASC 842 is economically similar to the acquisition of the underlying asset.</p> <p>Therefore, lessees should account for finance lease ROU assets entered into for R&amp;D activities by applying the recognition guidance in ASC 730, <i>Research and Development</i>, applicable to items of property, plant and equipment purchased or constructed solely for a particular R&amp;D project, unless a scope exception applies (see ASC 730-10-15-4 and 15-5). Accordingly, if the ROU asset has no alternative future uses (in other R&amp;D projects or otherwise), the finance lease ROU asset is expensed as R&amp;D costs at lease commencement.</p> | <p>ASC 842 continues to differentiate the financial statement reporting between operating and finance leases (see paragraph BC57 of ASU 2016-02). Also, as discussed in paragraph BC388 of ASU 2016-02, other than recognizing operating leases on balance sheet, the accounting for operating leases in a lessee's income statement or statement of cash flows is substantially the same as that in previous GAAP.</p> <p>Therefore, and because U.S. GAAP is not clear on this question, we believe an entity may apply either of the following approaches consistently for operating lease ROU assets that have no future alternative uses:</p> <ul style="list-style-type: none"> <li>▶ Expense the ROU asset at the commencement date under ASC 730 (like finance leases).</li> <li>▶ Continue to recognize the ROU asset and apply the general subsequent measurement guidance in ASC 842-20, including impairment considerations under ASC 360.</li> </ul> |

<sup>11</sup> See discussion on evaluation of alternative future uses in Chapter 3 of the AICPA's Accounting and Valuation Guide: *Assets Acquired to Be Used in Research and Development Activities*.

Example 6 below illustrates the initial measurement of a lease on balance sheet.

Also note that for the illustrations throughout this Chapter:

- a) The fact pattern in Example 6 will serve as the basis for most of the subsequent Examples in this Chapter.
- b) The tables presented in each Example are consistent with how they would be displayed in a spreadsheet, with amounts shown with no decimals, and no rounding function used.

#### EXAMPLE 6 - INITIAL MEASUREMENT OF LEASE LIABILITY AND RIGHT-OF-USE ASSET

##### FACTS

- ▶ Retailer Co. enters into a 10-year lease for 10,000 square feet of retail space.
- ▶ Annual lease payment is initially \$100,000, paid in arrears, and increases 5 percent each year during the lease term.
- ▶ The rate implicit in the lease is not readily determinable. Retailer Co's incremental borrowing rate (IBR) at lease commencement is 6 percent.
- ▶ The lease does not transfer ownership of the retail space to Retailer Co or grant it an option to purchase the space.
- ▶ Retailer Co. does not provide a residual value guarantee.
- ▶ At the commencement date, the lessor paid Retailer Co \$30,000 as an incentive to enter into the lease.
- ▶ Retailer Co. incurred the following costs related to the lease:
  - \$10,000 for employee wages for negotiating lease terms and conditions.
  - \$20,000 for commissions paid to a broker.
  - \$15,000 for external legal fees.
- ▶ There are no nonlease components.
- ▶ Assume the lease is classified as an operating lease.

## ANALYSIS

- ▶ The lease payments are discounted using a 6% discount rate (that is, Retailer Co's IBR), since the rate implicit in the lease is not readily determinable.
- ▶ The lease incentive of \$30,000 is reflected in the initial measurement of the right-of-use asset but does not affect the initial measurement of the lease liability, since it was received at the commencement date.
- ▶ The lease liability at the commencement date is \$904,337, calculated as follows:

| PMT                      |                  |
|--------------------------|------------------|
| Year 1                   | 100,000          |
| Year 2                   | 105,000          |
| Year 3                   | 110,250          |
| Year 4                   | 115,763          |
| Year 5                   | 121,551          |
| Year 6                   | 127,628          |
| Year 7                   | 134,010          |
| Year 8                   | 140,710          |
| Year 9                   | 147,746          |
| Year 10                  | 155,133          |
| <b>Undiscounted PMTs</b> | <b>1,257,789</b> |
| <b>PV(6%) =</b>          | <b>904,337</b>   |

- ▶ Retailer Co. recognizes as initial direct costs only the fees paid to the broker. This is because the external legal fees and employee wages would have been incurred even if Retailer Co. had not obtained the lease.
- ▶ Retailer Co. initially measures the right-of-use asset at \$894,337, calculated as follows:

|  |                   |
|--|-------------------|
| Initial measurement of the lease liability | \$ 904,337        |
| Plus, prepaid lease payments               | -                 |
| Plus, initial direct costs                 | 20,000            |
| Less, lease incentive received             | (30,000)          |
| <b>Initial measurement of ROU asset</b>    | <b>\$ 894,337</b> |

- ▶ Accordingly, at the commencement date, Retailer Co records the following entry:

|                     | \$      | \$      |
|---------------------|---------|---------|
| Right-of-use asset  | 894,337 |         |
| Operating expenses* | 25,000  |         |
| Lease liability     |         | 904,337 |
| Cash**              |         | 15,000  |

\* Legal fees and employee wages. For simplification, this Example assumes that those expenses are incurred at the commencement date.

\*\* All of Retailer Co's expenses less the lease incentive. For simplification, this Example assumes that initial direct costs and the operating expenses were incurred and paid at the commencement date.

- ▶ Note that initial measurement of the lease on balance sheet is the same regardless of lease classification.
- ▶ Subsequent accounting will be discussed in the following sections.

## 5.6 SUBSEQUENT MEASUREMENT

### 5.6.1 Finance Leases

After the commencement date, a lessee accounts for its finance leases as follows in its financial statements (absent impairments, modifications and reassessments, which are discussed later):

|                   | FINANCE LEASES   |   |
|-------------------|--|---|
|                   | ROU ASSET  | LEASE LIABILITY   |
| Balance Sheet     | <p>Amortize the ROU asset on a straight-line basis (unless another systematic basis is more representative of the pattern in which the lessee expects to consume the economic benefits of the ROU asset) from the commencement date to the earlier of the end of its useful life or lease term.</p> <p>However, if the lease transfers ownership of the underlying asset to the lessee or the lessee is reasonably certain to exercise a purchase option, the lessee amortizes the right-of-use asset to the end of the asset's useful life.</p> | Increase the lease liability to reflect interest using the interest method and decrease it for lease payments made during the period. |
| Income Statement* | <p>Recognize amortization of the ROU asset.</p> <p>Recognize variable lease payments not included in the lease liability when incurred. If variable lease payments are triggered based on a specified target, recognize costs from those variable lease payments before the achievement of such target if achievement is probable. Such variable lease costs should be reversed when it is probable the specified target will not be met.</p>  | <p>Recognize interest on the lease liability.</p>   |

\* Unless the costs are included in the carrying amount of another asset in accordance with other Topics.

As described above and as previously discussed, the accounting for a finance lease is consistent with the accounting for a financed purchase of PP&E. This is because the FASB generally viewed finance leases as economically similar to the purchase of a nonfinancial asset.

The lease liability is measured on an amortized cost basis and essentially reflects at each reporting period the present value of the remaining lease payments discounted using the discount rate established at lease commencement (or at the most recent lease modification not accounted for as a separate contract, or the most recent remeasurement resulting from a reassessment of the lease term or purchase option, as discussed later in this Chapter).

The ROU asset is measured at cost, net of accumulated amortization, and is amortized typically on a straight-line basis, like PP&E under ASC 360.

### 5.6.1.1 Amortization of ROU Asset Associated With a Finance Lease of Land

A lessee may classify a lease of land as a finance lease if any of the criteria in ASC 842-10-25-2 are met (see Section 4.9). Because land is considered to have an indefinite useful life, a question may arise regarding the amortization of the ROU asset related to a finance lease of land. Based on discussions with the FASB staff, we believe that it is appropriate for a lessee to not amortize the ROU asset associated with a finance lease of land if the lease is classified as a finance lease because:

- ▶ Title to the land transfers to the lessee by the end of the lease term, or
- ▶ The lease includes a purchase option that the lessee is reasonably certain to exercise.

We believe this is consistent with the guidance in ASC 842-20-35-8 which notes that when one of the two conditions above is met for a lease, the lessee amortizes the ROU asset to the end of the underlying asset's useful life, which is indefinite for land.

### 5.6.1.2 Variable Lease Payments Based on Achievement of a Target

Lessees recognize variable lease payments in the period in which they are incurred, pursuant to the guidance in ASC 842-20-25-5(b) and 25-6(b). ASC 842-20-55-1 and 55-2 provide additional guidance when such payments are based on a cumulative target. Specifically, if variable lease payments are triggered based on a specified target, then the costs are recognized before achievement of that target assuming achievement is probable. The FASB included this provision to ensure that lease payments are recognized in the periods in which the lessee benefits from use of the leased asset.

For example, consider a situation in which an entity leases a vehicle for three years for \$10,000 per year. If the lessee drives the car for more than 12,000 miles during the three-year period, then the lease requires it to pay an extra \$1,200. Assume that at lease commencement, it is probable the lessee will drive the car more than 12,000 miles during the lease term. Under the guidance in ASC 842-10-55-1, the lessee must accrue the additional \$1,200 payment before it reaches 12,000 miles and therefore would recognize the additional \$1,200 over the three-year lease term.

In contrast, if the lease required the lessee to pay \$7,000 per year plus \$1 for every mile driven, the lessee would not assess probability and instead would recognize the \$1 every time it drives one mile, in accordance with ASC 842-20-25-5.

**EXAMPLE 6.1 - SUBSEQUENT MEASUREMENT OF LEASE LIABILITY AND RIGHT-OF-USE ASSET - FINANCE LEASE****FACTS**

- ▶ Assume the same facts as in Example 6 apply, in which the ROU asset and lease liability were initially measured at \$894,337 and \$904,337 respectively, except that:
  - The lease is for a manufacturing equipment rather than retail space.
  - The remaining economic life of the equipment at lease commencement is 12 years.

**ANALYSIS**

- ▶ Retailer Co. classifies the lease as a finance lease in accordance with ASC 842-10-25-2(c) as the lease term (10 years) is for the major part of the remaining economic life of the underlying asset.
- ▶ As there is no transfer of ownership or purchase option, the right-of-use asset is amortized from the commencement date to the earlier of the useful life of the right-of-use asset and the lease term, which in this Example is 10 years.
- ▶ Lease liability accounting throughout the lease term (assuming no modifications and remeasurements)

|                | Beg.<br>balance | Interest<br>(6%) | PMT      | Closing<br>balance |
|----------------|-----------------|------------------|----------|--------------------|
| <b>Year 1</b>  | 904,337         | 54,260           | -100,000 | 858,598            |
| <b>Year 2</b>  | 858,598         | 51,516           | -105,000 | 805,114            |
| <b>Year 3</b>  | 805,114         | 48,307           | -110,250 | 743,170            |
| <b>Year 4</b>  | 743,170         | 44,590           | -115,763 | 671,998            |
| <b>Year 5</b>  | 671,998         | 40,320           | -121,551 | 590,767            |
| <b>Year 6</b>  | 590,767         | 35,446           | -127,628 | 498,585            |
| <b>Year 7</b>  | 498,585         | 29,915           | -134,010 | 394,491            |
| <b>Year 8</b>  | 394,491         | 23,669           | -140,710 | 277,450            |
| <b>Year 9</b>  | 277,450         | 16,647           | -147,746 | 146,352            |
| <b>Year 10</b> | 146,352         | 8,781            | -155,133 | 0                  |

- ▶ Right-of-use asset amortization calculation

Annual amortization:  $894,337 / 10 = 89,434$

- ▶ Journal entries (Year 1 shown only)

|                      | \$      | \$      |
|----------------------|---------|---------|
| Interest expense     | 54,260  |         |
| Lease liability      |         | 54,260  |
|                      |         |         |
| Lease liability      | 100,000 |         |
| Cash                 |         | 100,000 |
|                      |         |         |
| Amortization expense | 89,434  |         |
| Right-of-use asset   |         | 89,434  |

## 5.6.2 Operating Leases

After the commencement date, a lessee accounts for its operating leases as follows in its financial statements (absent impairments, modifications and reassessments, which are discussed later):

| OPERATING LEASES  |  |   |
|-------------------|--|---|
|                   | ROU ASSET  | LEASE LIABILITY   |
| Balance Sheet     | <p>ROU asset equals the amount of the lease liability, adjusted for prepaid or accrued lease payments, unamortized lease incentives, and unamortized initial direct costs.</p> <p>Alternatively, amortize the ROU asset for the difference between the periodic lease cost and periodic interest on the lease liability (see discussion below).</p>  | Increase the lease liability to reflect interest using the interest method and decrease it for lease payments made during the period. |
| Income Statement* | Recognize a single lease cost (i.e., lease payments plus initial direct costs) generally on a straight-line basis over the lease term, unless another systematic basis is more representative of the pattern in which the lessee expects to consume the economic benefits of the ROU asset.  |   |
|                   | Recognize variable lease payments not included in the lease liability when incurred. If variable lease payments are triggered based on a specified target, recognize costs from those variable lease payments before the achievement of such target if achievement is probable. Such variable lease costs should be reversed when it is probable the specified target will not be met. See Section 5.6.1.2 for further discussion. |   |

\* Unless the costs are included in the carrying amount of another asset in accordance with other Topics.

As previously discussed, the FASB concluded that operating leases are different from finance leases and purchases of nonfinancial assets. Consequently, ASC 842 provides for different financial statement reporting of operating leases from that of finance leases. The legacy guidance in ASC 840 required lessees to recognize operating lease expense generally on a straight-line basis. This continues under ASC 842 whereby a lessee recognizes a single lease cost for operating leases based on the pattern in which the benefits conveyed by the lease are consumed, which is generally (though not always) on an equal basis over the lease term.

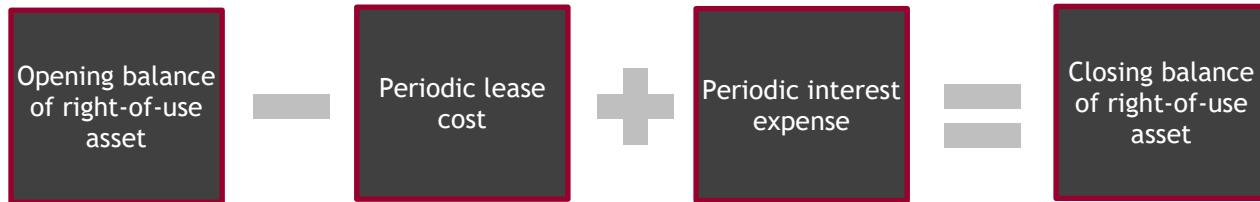
The lessee's initial and subsequent accounting for operating lease liabilities is the same as for finance leases (i.e., reflecting the present value of the remaining lease payments), based on the view that the lessee should measure lease liabilities in a manner similar to other similar financial liabilities (that is, on an amortized cost basis), regardless of lease classification.

With the FASB's intention to retain straight line expense recognition in the income statement while also accreting interest on the lease liability under the interest method like other financial liabilities, the amortization of the ROU asset essentially is the difference between the periodic lease cost and periodic interest accretion. Accordingly, while ASC 842-20-35-3 describes the subsequent measurement of the right-of-use asset as shown in the table above (assuming no impairment of the right-of-use asset), the lessee can determine the carrying value of right-of-use asset in subsequent periods from the periodic lease cost and interest accretion.

Initially, the total lease cost of an operating lease consists of the following:

- ▶ The total lease payments (including those paid and those not yet paid); plus
- ▶ The initial direct costs attributable to the lease.

Therefore, the periodic lease cost is the total lease cost divided by the lease term. Once the periodic lease cost is determined, the carrying value of the ROU asset at each reporting period can be calculated as follows:



In other words, the periodic amortization of the right-of-use asset equals the difference between the periodic lease cost and the periodic interest expense.

#### EXAMPLE 6.2 - SUBSEQUENT MEASUREMENT OF LEASE LIABILITY AND RIGHT-OF-USE ASSET - OPERATING LEASE

##### FACTS

- ▶ Assume the same facts as in Example 6, in which:
  - The ROU asset and lease liability were initially measured at \$894,337 and \$904,337 respectively,
  - The unpaid lease payments were \$1,257,789 on an undiscounted basis,
  - Initial direct costs were \$20,000, and lease incentives received were \$30,000, and
  - The lease is an operating lease.

##### ANALYSIS

- ▶ The accounting for the lease liability is the same as in Example 6.1, assuming no modifications and remeasurements, since there are no differences in accounting between operating lease liabilities and finance lease liabilities.
- ▶ Right-of-use asset accounting

Retailer Co. first calculates the total lease cost to be recognized over the lease term:

|   |                     |
|---|---------------------|
| Total lease payments (paid and not yet paid)* | \$ 1,227,789        |
| Plus, initial direct costs                    | 20,000              |
| Total lease cost [A]                          | <u>\$ 1,247,789</u> |
| <b>Periodic lease cost [B] = [A] / 10</b>     | <b>\$ 124,779</b>   |

\* This amount reflects the total lease payments of \$1,257,789, less the lease incentive received of \$(30,000).

- ▶ Therefore, the accounting for the ROU asset, assuming no impairment, modifications or reassessments, can be determined as follows:

|         | Opening balance<br>[A] | Periodic lease cost<br>[B] | Interest<br>(6%)<br>[C] | Amortization<br>[D] = [B] + [C]<br>[A] + [D] | Closing balance |
|---------|------------------------|----------------------------|-------------------------|--|-----------------|
| Year 1  | 894,337                | -124,779                   | 54,260                  | -70,519                                      | 823,819         |
| Year 2  | 823,819                | -124,779                   | 51,516                  | -73,263                                      | 750,556         |
| Year 3  | 750,556                | -124,779                   | 48,307                  | -76,472                                      | 674,084         |
| Year 4  | 674,084                | -124,779                   | 44,590                  | -80,189                                      | 593,895         |
| Year 5  | 593,895                | -124,779                   | 40,320                  | -84,459                                      | 509,436         |
| Year 6  | 509,436                | -124,779                   | 35,446                  | -89,333                                      | 420,103         |
| Year 7  | 420,103                | -124,779                   | 29,915                  | -94,864                                      | 325,239         |
| Year 8  | 325,239                | -124,779                   | 23,669                  | -101,109                                     | 224,130         |
| Year 9  | 224,130                | -124,779                   | 16,647                  | -108,132                                     | 115,998         |
| Year 10 | 115,998                | -124,779                   | 8,781                   | -115,998                                     | 0               |

- ▶ Journal entries (Year 1 shown only)

|                    | \$      | \$      |
|--------------------|---------|---------|
| Lease liability    | 100,000 |         |
| Cash               |         | 100,000 |
| Lease expense      | 124,779 |         |
| Right-of-use asset |         | 70,519  |
| Lease liability    |         | 54,260  |



#### OPERATING LEASE ROU ASSETS SUBSEQUENT MEASUREMENT DIFFERS FROM FINANCE LEASES

As illustrated above and previously discussed, the lease cost of an operating lease is comprised of both amortization and interest but it is recognized as a single cost generally on a straight-line basis over the lease term.

Under the interest method, the periodic accretion of interest on the lease liability is higher in the early periods of the lease than in the later periods, and interest amounts accrued decrease over time as lease payments are made.

Accordingly, the amount attributed to the amortization of the right-of-use asset will be correspondingly lower in the early periods and will increase over time. Therefore, in the early periods of the lease, the right-of-use asset balance under operating leases will be higher than the right-of-use asset balance for finance leases. However, the total lease cost recognized over the entire lease term is the same.

ASC 842 also notes that throughout the lease term, the remaining cost of an operating lease for which the right-of-use asset has not been impaired consists of the following:

- ▶ The total lease payments (including those paid and those not yet paid), reflecting any adjustment to that total amount resulting from either a remeasurement or a modification (see Sections 5.7 and 5.8, respectively);
- ▶ Plus, the initial direct costs attributable to the lease;
- ▶ Less, the periodic lease cost recognized in prior periods.

However, if there are no modifications or reassessments and the operating lease ROU asset is not impaired, the periodic lease cost remains the same throughout the lease term as illustrated in Example 6.2 above, and it does not need to be recomputed each reporting period.

For example, the remaining lease cost of the lease in Example 6.2 at the end of Year 2 would be calculated as follows and would result in the same periodic lease cost as in Year 1:

|   |                          |                             |
|---|--------------------------|-----------------------------|
| Total lease payments (paid and not yet paid)          | \$ 1,227,789             | (see table in Example 6.2)  |
| Plus, initial direct costs                            | 20,000                   | (same as in Example 6.2)    |
| Less, periodic lease cost recognized in Years 1 and 2 | <u>(249,558)</u>         | (i.e., \$124,779 x 2 years) |
| Total lease cost [A]                                  | <u><u>\$ 998,231</u></u> |                             |
| <b>Periodic lease cost [B] = [A] / 8 years left</b>   | <b>\$ 124,779</b>        |                             |

Also note that, because the amortization of the ROU asset is the difference between the periodic lease cost and periodic interest accretion, the remaining lease cost (and periodic lease cost) could also be determined as follows:

|   |                          |                          |
|---|--------------------------|--------------------------|
| Carrying value of ROU asset at end of Year 2        | \$ 750,556               | (same as in Example 6.2) |
| Plus, sum of interest accretion Years 3 - 10        | <u>247,675</u>           |                          |
| Total remaining lease cost [A]                      | <u><u>\$ 998,231</u></u> |                          |
| <b>Periodic lease cost [B] = [A] / 8 years left</b> | <b>\$ 124,779</b>        |                          |

**EXAMPLE 5 - OPERATING LEASE WITH NON-CONSECUTIVE PERIODS, SUBSEQUENT MEASUREMENT OF LEASE LIABILITY AND RIGHT-OF-USE ASSET (CONTINUED)**

**FACTS**

- ▶ Let's continue with Example 5 in which Lessee is a basketball association that wishes to host its playoff games in a large venue each season.
- ▶ In July 2021, Lessee entered into a lease with Ball-is-Life Co. for the use of two basketball arenas during the months of May and June each year during a 10-year period, starting in May 2022.
- ▶ At lease inception, Lessee paid Lessor \$150,000.
- ▶ Payments are \$150,000 for each month during which Lessee has the right to use the arenas and is due at the end of the month (that is, \$150,000 is due May 31, 2022, \$150,000 is due June 30, 2022, no payments are due from July 2022 to April 2023, etc.).
- ▶ The lease contract does not include any options (extension, termination or purchase) and Lessee did not provide a residual value guarantee.
- ▶ There are no nonlease components.
- ▶ Lessee did not incur any initial direct costs or receive any lease incentives.
- ▶ Lessee made an accounting policy election not to recognize right-of-use assets and lease liabilities that arise from short-term leases for any class of underlying asset. However, as discussed and illustrated in Example 5 in Section 5.4, the lease does not qualify for the short-term lease exception because the lease term is 20 months.
- ▶ The rate implicit in the lease is not readily determinable. Lessee's incremental borrowing rate at lease commencement is 6%.
- ▶ Assume the lease is an operating lease.
- ▶ For simplicity, assume that Lessee's fiscal year ends June 30.

**ANALYSIS**

- ▶ As discussed in Section 5.5.1, a lessee recognizes a lease on balance sheet at the lease's commencement date, which is May 1, 2022, in this example.
- ▶ From lease inception (July 2021) through April 2022, Lessee's balance sheet reflects only a prepaid lease payment of \$150,000.
- ▶ During those periods, Lessee discloses the forward starting lease in accordance with ASC 842-20-50-3(b).
- ▶ On May 1, 2022 (commencement date of the lease), Lessee recognizes the lease on balance sheet. The prepaid lease payment of \$150,000 is reclassified and included in the initial measurement of the ROU asset.
- ▶ Lessee calculates the total lease cost to be recognized over the lease term:

|   |                     |
|---|---------------------|
| Total lease payments (paid and not yet paid)* | \$ 3,150,000        |
| Plus, initial direct costs                    | —                   |
| Total lease cost [A]                          | <u>\$ 3,150,000</u> |
| <b>Periodic lease cost [B] = [A] / 20**</b>   | <b>\$ 157,500</b>   |

\* This amount reflects the total lease payments that Lessee will make during the lease term (20 payments of \$150,000, or \$3,000,000) plus the prepayment of \$150,000 it made at lease inception.

\*\* 2 months per year x 10 years.

- ▶ Lessee recognizes a periodic lease expense of \$157,500 each month Lessee uses the arenas (i.e., May and June of each year during the lease term).
- ▶ For the periods from July to April, Lessee recognizes no lease expense.

- The following table summarizes Lessee's accounting for the lease during the lease term, assuming no impairment, reassessments or modifications.

|           | <u>Lease Liability</u> |          |          |             | <u>ROU Asset</u> |          |             |
|-----------|------------------------|----------|----------|-------------|------------------|----------|-------------|
|           | Beg. Bal.              | Interest | PMT      | Ending Bal. | Beg. Bal.        | Amort.   | Ending Bal. |
| Year 1*** | 2,308,363              | 22,391   | -300,000 | 2,030,754   | 2,458,363        | -292,609 | 2,165,754   |
| Year 2    | 2,030,754              | 124,502  | -300,000 | 1,855,257   | 2,165,754        | -190,498 | 1,975,257   |
| Year 3    | 1,855,257              | 113,678  | -300,000 | 1,668,935   | 1,975,257        | -201,322 | 1,773,935   |
| Year 4    | 1,668,935              | 102,186  | -300,000 | 1,471,121   | 1,773,935        | -212,814 | 1,561,121   |
| Year 5    | 1,471,121              | 89,986   | -300,000 | 1,261,107   | 1,561,121        | -225,014 | 1,336,107   |
| Year 6    | 1,261,107              | 77,032   | -300,000 | 1,038,139   | 1,336,107        | -237,968 | 1,098,139   |
| Year 7    | 1,038,139              | 63,280   | -300,000 | 801,419     | 1,098,139        | -251,720 | 846,419     |
| Year 8    | 801,419                | 48,680   | -300,000 | 550,099     | 846,419          | -266,320 | 580,099     |
| Year 9    | 550,099                | 33,179   | -300,000 | 283,278     | 580,099          | -281,821 | 298,278     |
| Year 10   | 283,278                | 16,722   | -300,000 | —           | 298,278          | -298,278 | —           |

\*\*\* Fiscal year ended June 30, 2022. The beginning balances for this lease in the amounts of \$2,308,363 (lease liability) and \$2,458,363 (ROU asset) reflect a May 1, 2022, commencement date.

- If Lessee issues quarterly financial statements, the following table summarizes the quarterly financial data associated with Lessee's lease of the arenas for the quarters from July 1, 2022, to June 30, 2023 (i.e., Year 2 in the above table).

|    | <u>Lease Liability</u> |          |          |             | <u>ROU Asset</u> |            |             |
|----|------------------------|----------|----------|-------------|------------------|------------|-------------|
|    | Beg. Bal.              | Interest | PMT      | Ending Bal. | Beg. Bal.        | Amort.     | Ending Bal. |
| Q1 | 2,030,754              | 30,614   | —        | 2,061,368   | 2,165,754        | 30,614**** | 2,196,368   |
| Q2 | 2,061,368              | 31,075   | —        | 2,092,444   | 2,196,368        | 31,075     | 2,227,444   |
| Q3 | 2,092,444              | 31,544   | —        | 2,123,987   | 2,227,444        | 31,544     | 2,258,987   |
| Q4 | 2,123,987              | 31,269   | -300,000 | 1,855,257   | 2,258,987        | -283,731   | 1,975,257   |

\*\*\*\* As discussed earlier in Section 5.6.2, the periodic amortization of the ROU asset can be calculated as the difference between the periodic lease cost and periodic interest on the lease liability. Because the periodic lease cost is recognized only during the periods of use (that is, May and June), for the other periods the balance of the ROU asset increases by the amount of the periodic interest on the lease liability.

### 5.6.3 Leasehold Improvements

#### 5.6.3.1 Leasehold Improvements – Leases Other Than Common Control

Leasehold improvements are amortized over the shorter of the useful life of those improvements and the remaining lease term, unless the lease transfers ownership of the underlying asset to the lessee or the lessee is reasonably certain to exercise an option to purchase the underlying asset, in which case the lessee amortizes the leasehold improvements to the end of their useful life. Also, as discussed in Chapter 4, the existence of significant leasehold improvements with a useful life longer than the noncancelable term of the lease may indicate that it is reasonably certain that the lessee will exercise a renewal option. Therefore, the useful life of the improvements should be considered when determining the remaining lease term.

#### 5.6.3.2 Leasehold Improvements – Common Control Leases

Private company stakeholders raised concerns about amortization of leasehold improvements in common control leases in accordance with Section 5.6.3.1 above. Common control leases often have a short lease term (for example, one year), even if the lessee makes significant leasehold improvements with an estimated useful life significantly longer than the lease term (for example, 10 years). According to private company stakeholders, amortizing the significant leasehold improvements over the lease term does not result in economically faithful information when the lessee and lessor are under common control because the common control group benefits from the improvements, either by extending the lease with the lessee after the expiration of the initial lease or by transferring the assets to the lessor or another entity within the common control group.

In response to those concerns, the FASB issued ASU 2023-01, Leases (Topic 842): *Common Control Arrangements*. ASU 2023-01 states that:

- ▶ A lessee amortizes leasehold improvements associated with a lease between entities under common control over the useful life of those improvements to the common control group, regardless of the lease term, if the lessee controls the use of the underlying asset through a lease. If the lessor obtained the right to control the underlying asset's use through a lease with another entity outside the common control group, then the amortization period cannot exceed the amortization period of the common control group determined in accordance with ASC 842-20-35-12.
- ▶ If the lessee loses control of the use of the leased asset to another entity in the common control group, the remaining balance of leasehold improvements is accounted for as a transfer between entities under common control through an adjustment to equity (or net assets for a not-for-profit entity).

While the FASB received concerns about the requirements in ASC 842 mostly from private company stakeholders, it concluded that these changes better reflect the economics of leasehold improvements in leases between entities under common control and therefore the changes apply to all entities.

In response to the changes discussed above, the FASB also clarified that leasehold improvements associated with common control leases are:

- ▶ Not considered lease payments
- ▶ Assessed for impairment by applying the guidance in ASC 360, *Property, Plant and Equipment*, for long-lived assets to be exchanged or distributed to owners in a spinoff, considering the improvements' useful life to the common control group.<sup>12</sup>

After a lease's commencement date, any change in the amortization period for leasehold improvements because of a change in a common control relationship is accounted for prospectively as a change in accounting estimate.

<sup>12</sup> ASC 360-10-40-4

**BDO INSIGHT – PROCESSES AND CONTROLS CONSIDERATIONS**

Unlike the practical expedient on evaluating terms and conditions of a lease (see Section 2.5), the guidance on amortization and transfers of leasehold improvements in common control leases applies to both public and nonpublic entities. This means that public and nonpublic entities need to identify changes to common control relationships after a lease's commencement date on a timely basis, and account for the resulting change for the leasehold improvements prospectively. Entities should consider whether they need to specifically track information or other events in their lease system or manually that are not otherwise monitored for lease accounting.

The FASB did not address how to determine which party to the common control lease is the accounting owner of improvements made to a leased asset. The FASB acknowledged that various reasonable approaches exist in practice and, therefore, decided not to provide guidance in ASU 2023-01.<sup>13</sup> See Section 4.2 for further discussion.

For disclosure requirements, see Section 8.3.2.

For transition to ASC 842 related to existing common control leases, see Section 9.6.4.

**5.6.3.3 Leasehold Improvements Acquired in a Business Combination or Acquisition by Not-for-Profit**

Leasehold improvements acquired in a business combination or an acquisition by a not-for-profit entity are amortized over the shorter of the useful life of the assets and the remaining lease term at the date of acquisition.

<sup>13</sup> BC40 of the Update.

## 5.7 REMEASUREMENTS

We discussed above the recognition and initial measurement of a lessee's leases on balance sheet, which are based in part on certain assumptions and judgment, such as assessing lessee options to extend or terminate the lease, or lessee options to purchase the underlying asset. The Board noted in paragraph BC227 of ASU 2016-02 that "users of financial statements receive more relevant information when entities reassess options on a regular basis because reassessment reflects current economic conditions. For example, using a lease term established at lease commencement throughout the lease could be misleading if there has been a change in facts or circumstances from those that existed at lease commencement." But the Board also noted that requiring reassessment of those options at each reporting date would be costly for a lessee with many leases; and therefore, it limited this reassessment to certain specific events.

The FASB also considered situations in which entities might attempt to circumvent the balance sheet recognition of leases. For example, a lease may initially provide for only nominal lease payments, or payments that are variable, but which become fixed for the remainder of the lease term at a later date. Absent a remeasurement, the lessee would continue to report a right-of-use asset and lease liability with little to no value. The FASB therefore requires lessees to also remeasure the lease payments when a contingency on which some or all of the variable lease payments are based is resolved such that the payments become fixed (the payments now meet the definition of lease payments).

Finally, the FASB decided that lessees should reassess amounts probable of being owed under residual value guarantees because it provides more relevant information to users and reflects current economic conditions.

In summary, other than modifications which are discussed later, the FASB decided that after the commencement date, a lessee should remeasure the lease payments only upon the occurrence of any of the following events:

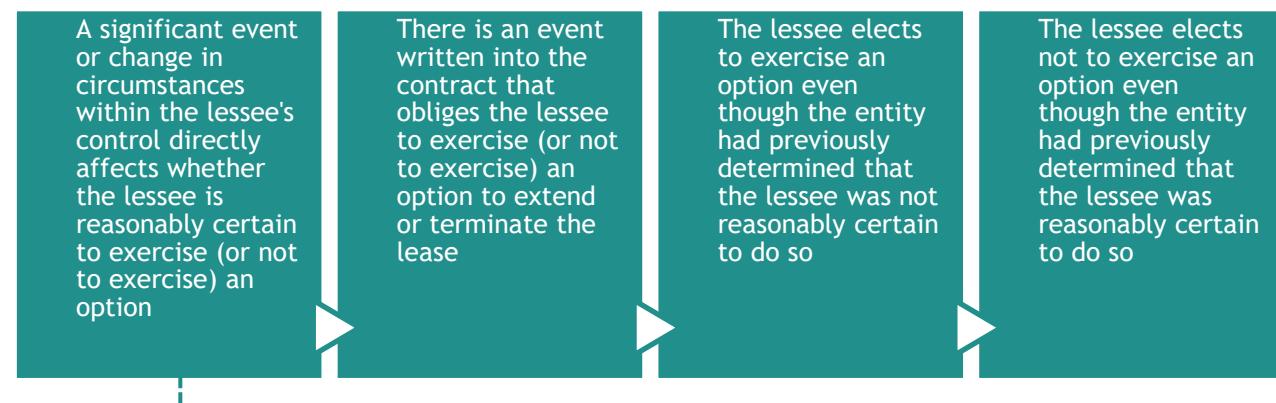
| REMEASUREMENT EVENT  | GENERAL ACCOUNTING APPLICABLE TO ALL REMEASUREMENT EVENTS   | UPDATE THE DISCOUNT RATE?   | REASSESS LEASE CLASSIFICATION? |
|--|---|---|--------------------------------|
| A change in the lease term or the assessment of whether the lessee is reasonably certain to exercise a purchase option                       | <ul style="list-style-type: none"> <li>▶ Remeasure the lease payments and the consideration in the contract,</li> <li>▶ Reallocate the consideration to the lease and nonlease components (unless the practical expedient not to separate is elected), and</li> <li>▶ Remeasure the lease liability and recognize the remeasurement amount as an adjustment to the ROU asset. However, if the carrying amount of the ROU asset is reduced to zero, the remaining amount is recognized in profit or loss.</li> </ul> | Yes, unless the discount rate already reflects a lessee's extension, termination or purchase option | Yes                            |
| A contingency upon which some or all of the variable lease payments in the lease are based is resolved such that those payments become fixed |   | No  | No                             |
| A change in the amount probable of being owed to the lessor under a residual value guarantee   |   | No  | No                             |

Note the following as well:

- ▶ When the lessee updates the discount rate, it is performed at the remeasurement date based on the remaining lease term and the remaining lease payments.
- ▶ When lease classification is reassessed, it is done based on the facts and circumstances at the reassessment date (e.g., based on the fair value and remaining economic life of the underlying asset at that date).
- ▶ A lessee does not remeasure variable lease payments that depend on an index or a rate unless the lease liability is remeasured for another reason (i.e., based on one of the above remeasurement events).

### 5.7.1 Change in Lease Term or Assessment of Purchase Options

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



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

- ▶ Constructing leasehold improvements that are expected to have significant value when the option becomes exercisable;
- ▶ Making significant modifications or customizations to the underlying asset;
- ▶ Making a business decision that is directly relevant to the ability to exercise an option such as extending the lease of a complementary asset; and
- ▶ Subleasing the underlying asset for a period beyond the exercise date of the option.

However, note that:

- ▶ Changes in market factors, such as market rates to lease comparable assets, do not in isolation trigger a reassessment.
- ▶ A requirement to test an asset group that includes the right-of-use asset for impairment does not necessarily result in a requirement to reassess the lease term or purchase options. Rather, the lessee should determine whether the impairment triggering event represents a requirement to reassess the lease term or purchase option. For example, an asset group that is tested for impairment because of a history of cash flow losses or because of a significant decrease in the market price of a long-lived asset in isolation may not require a reassessment of the lease term or purchase options.

Business decisions affect key estimates such as the lease term and the assessment of lessee purchase options. Therefore, a lessee should work with business partners in the organization to develop a process to identify and track which type of decisions are relevant to the assessment and when these decisions are made, such that these estimates affecting the lease liability are updated timely for the financial statements. These decisions may not have a formal paper trail and will need to be documented to arrive at key decisions regarding these estimates.

The requirements for a lessee to remeasure the lease payments for changes in the lease term and assessment of lessee purchase options, remeasure and reallocate the consideration in the contract, remeasure the lease liability, update the discount rate (except when the discount rate already reflects a lessee's option), and reassess lease classification will therefore require an entity to implement robust processes and controls to completely and timely identify events requiring such remeasurements.

**EXAMPLE 6.3A - REASSESSMENT OF THE LEASE TERM - OPERATING LEASE****FACTS**

- ▶ Assume the same facts as in Example 6 and Example 6.2 apply, in which the lease of the retail space is an operating lease. Also assume the following:
  - The contract provides Retailer Co. with the option to extend the lease for an additional 10 years.
  - Annual lease payments during the optional period are \$150,000.
  - At the commencement date, Retailer Co. concluded it was not reasonably certain to exercise the extension option because payments in the renewal period are substantially the same as the amount otherwise due in the final year of the initial period, there is significant uncertainty as to whether Retailer Co. will need the underlying asset after ten years, and Retailer Co. did not construct improvements with an economic life longer than the initial term. Therefore, Retailer Co. determined that the lease term was 10 years.
  - The discount rate for the lease of 6 percent at the commencement date does not reflect that Retailer Co. has an option to extend the lease.
  - At the beginning of Year 6 of the lease, the financial performance of the retail space is higher than initially expected, and Retailer Co. installs significant leasehold improvements. Those improvements are expected to have significant economic value for Retailer Co. at the end of Year 10. Consequently, construction of the leasehold improvements is considered a significant event or change in circumstances that directly affects whether Retailer Co. is reasonably certain to exercise the extension option.
- ▶ The initial accounting for the lease throughout the lease term, absent a remeasurement or modification, was discussed in the prior examples and is summarized in the following table:

|         | <u>Lease Liability</u> |          |          |             | <u>ROU Asset</u> |          |             |
|---------|------------------------|----------|----------|-------------|------------------|----------|-------------|
|         | Beg. Bal.              | Interest | PMT      | Ending Bal. | Beg. Bal.        | Amort.   | Ending Bal. |
| Year 1  | 904,337                | 54,260   | -100,000 | 858,598     | 894,337          | -70,519  | 823,819     |
| Year 2  | 858,598                | 51,516   | -105,000 | 805,114     | 823,819          | -73,263  | 750,556     |
| Year 3  | 805,114                | 48,307   | -110,250 | 743,170     | 750,556          | -76,472  | 674,084     |
| Year 4  | 743,170                | 44,590   | -115,763 | 671,998     | 674,084          | -80,189  | 593,895     |
| Year 5  | 671,998                | 40,320   | -121,551 | 590,767     | 593,895          | -84,459  | 509,436     |
| Year 6  | 590,767                | 35,446   | -127,628 | 498,585     | 509,436          | -89,333  | 420,103     |
| Year 7  | 498,585                | 29,915   | -134,010 | 394,491     | 420,103          | -94,864  | 325,239     |
| Year 8  | 394,491                | 23,669   | -140,710 | 277,450     | 325,239          | -101,109 | 224,130     |
| Year 9  | 277,450                | 16,647   | -147,746 | 146,352     | 224,130          | -108,132 | 115,998     |
| Year 10 | 146,352                | 8,781    | -155,133 | —           | 115,998          | -115,998 | —           |

## ANALYSIS

- ▶ Upon reassessing the lease term at the beginning of Year 6, Retailer Co. concludes that it is reasonably certain to exercise the option to extend the lease for an additional 10 years.
- ▶ Retailer Co. remeasures the lease payments (the consideration in the contract) to reflect the revised lease term. Since there are no nonlease components and there is only one lease component, there is no reallocation of the consideration necessary.
- ▶ Since the discount rate at commencement did not reflect Retailer Co. having the extension option, the discount rate is updated at the reassessment date. Considering the extended remaining lease term (15 years in total) and remaining lease payments, Retailer Co. determines that its incremental borrowing rate at the beginning of Year 6 is 8 percent.
- ▶ Retailer Co. reassesses lease classification based on the fair value of the underlying asset and remaining economic life at the beginning of Year 6. Assume the lease continues to be an operating lease.
- ▶ Retailer Co. remeasures the lease liability using the revised lease payments and updated discount rate. This results in an updated lease liability of \$1,243,959, or an increase of \$653,192 ( $1,243,959 - 590,767$ ).
- ▶ The remeasurement of the lease liability is recognized as an adjustment to the ROU asset. Accordingly, the carrying value of the ROU asset immediately after the remeasurement is \$1,162,628 ( $509,436 + 653,192$ ).
- ▶ Retailer Co. updates the periodic lease cost for the remainder of the lease (15 years) as follows:

|   |                     |
|---|---------------------|
| Total lease payments (paid and not yet paid)*           | \$ 2,727,789        |
| Plus, initial direct costs                              | 20,000              |
| Less, periodic lease cost recognized in prior periods** | <u>(623,895)</u>    |
| Total remaining lease cost [A]                          | <u>\$ 2,123,894</u> |
| <b>Periodic lease cost [B] = [A] / 15y</b>              | <b>\$ 141,593</b>   |

\* This amount reflects the total lease payments (including those paid in Years 1-5 and those not yet paid for Years 6-20), less the lease incentive received at the commencement date of \$30,000.

\*\* Prior periodic lease cost of  $\$124,779 \times 5$  years

- ▶ Following the remeasurement, Retailer Co. recognizes a single lease expense of \$141,593 each year for the remainder of the lease term assuming no impairment, modifications, or other reassessments.
- ▶ The amortization of the right-of-use asset is determined as the difference between the single lease cost of \$141,593, and the periodic interest accretion on the lease liability. For example, for Year 6 amortization of the right-of-use asset is \$42,076 ( $141,593 - 99,517$ ).

- The accounting for the lease after the remeasurement, and throughout the lease term (assuming no impairment, modifications, or other reassessments) is summarized in the following table:

|                | <u>Lease Liability</u> |          |          |             | <u>ROU Asset</u> |          |             |
|----------------|------------------------|----------|----------|-------------|------------------|----------|-------------|
|                | Beg. Bal.              | Interest | PMT      | Ending Bal. | Beg. Bal.        | Amort.   | Ending Bal. |
| <b>Year 6</b>  | 1,243,959              | 99,517   | -127,628 | 1,215,848   | 1,162,628        | -42,076  | 1,120,552   |
| <b>Year 7</b>  | 1,215,848              | 97,268   | -134,010 | 1,179,106   | 1,120,552        | -44,325  | 1,076,227   |
| <b>Year 8</b>  | 1,179,106              | 94,329   | -140,710 | 1,132,725   | 1,076,227        | -47,264  | 1,028,962   |
| <b>Year 9</b>  | 1,132,725              | 90,618   | -147,746 | 1,075,597   | 1,028,962        | -50,975  | 977,987     |
| <b>Year 10</b> | 1,075,597              | 86,048   | -155,133 | 1,006,512   | 977,987          | -55,545  | 922,442     |
| <b>Year 11</b> | 1,006,512              | 80,521   | -150,000 | 937,033     | 922,442          | -61,072  | 861,370     |
| <b>Year 12</b> | 937,033                | 74,963   | -150,000 | 861,996     | 861,370          | -66,630  | 794,740     |
| <b>Year 13</b> | 861,996                | 68,960   | -150,000 | 780,956     | 794,740          | -72,633  | 722,106     |
| <b>Year 14</b> | 780,956                | 62,476   | -150,000 | 693,432     | 722,106          | -79,117  | 642,990     |
| <b>Year 15</b> | 693,432                | 55,475   | -150,000 | 598,907     | 642,990          | -86,118  | 556,871     |
| <b>Year 16</b> | 598,907                | 47,913   | -150,000 | 496,819     | 556,871          | -93,680  | 463,191     |
| <b>Year 17</b> | 496,819                | 39,746   | -150,000 | 386,565     | 463,191          | -101,847 | 361,343     |
| <b>Year 18</b> | 386,565                | 30,925   | -150,000 | 267,490     | 361,343          | -110,668 | 250,676     |
| <b>Year 19</b> | 267,490                | 21,399   | -150,000 | 138,889     | 250,676          | -120,194 | 130,482     |
| <b>Year 20</b> | 138,889                | 11,111   | -150,000 | —           | 130,482          | -130,482 | —           |

### EXAMPLE 6.3B - REASSESSMENT OF THE LEASE TERM - OPERATING LEASE

#### FACTS

- Assume the same as in Example 6.3A, except that at the beginning of Year 6, Retailer Co. only refreshes the store and spends \$40,000 to repaint the interior of the store and reconfigure the floor space, including relocating the registers and certain fixed display racks.

#### ANALYSIS

- Although judgement would need to be applied, these expenditures are not typically considered leasehold improvements, but rather typical maintenance activities that should be expected in the life cycle of an asset. As such, in the above specific facts and circumstances, these expenditures would not trigger a reassessment event for Retailer Co. and would be expensed as incurred.



#### LEASE WITH REASSESSED LEASE TERM OR PURCHASE OPTION IS ACCOUNTED LIKE A NEW LEASE

The accounting for a lease that is remeasured because of a change in the assessment of the lease term or a purchase option is essentially like the accounting for a new lease, since the lessee reperforms all steps required for a new lease (e.g., measure and allocate the consideration in the contract, determine the discount rate, assess lease classification, etc.). This was illustrated in Example 6.3A above.

### 5.7.2. Resolution of Contingency Upon Which Variable Lease Payments Are Based

#### EXAMPLE 6.4 - RESOLUTION OF A CONTINGENCY - OPERATING LEASE

##### FACTS

- ▶ Assume the same facts as in Example 6 and Example 6.2 apply, in which the lease of the retail space is an operating lease. Also assume the following:
  - At lease inception, Retailer Co. was selling only Product A and was in the process of developing Product B, a product that would complement the use of, and increase the customer experience with, Product A.
  - In addition to the fixed annual payments described in Example 6, the contract requires Retailer Co. to pay annually as additional rent an amount equal to 2% of Retailer Co.'s sales. However, upon its launch of Product B, Retailer Co. will pay an additional annual payment amount for the remainder of the lease term of \$20,000 instead of the 2% payment on sales.
  - Retailer Co.'s sales in Years 1 and 2 are \$350,000 and \$500,000, respectively.
  - At the beginning of Year 3, Retailer Co. launches Product B in the market and starts selling it in the retail store.

##### ANALYSIS

- ▶ The payment determined as a percentage of sales is a variable lease payment that does not depend on an index or a rate. Therefore, it is recorded as a periodic variable lease expense and it does not affect the measurement of the lease liability. Retailer Co. recognizes variable lease expense of \$7,000 and \$10,000 in Years 1 and 2, respectively.
- ▶ At the beginning of Year 3 (when the contingency is resolved), Retailer Co. remeasures the lease payments in accordance with ASC 842-10-35-4(b) and discounts the revised lease payments using the original discount rate consistent with ASC 842-20-35-5(c). The remeasurement amount is recognized as an adjustment to the ROU asset.
- ▶ At the beginning of Year 3, the carrying value of the lease liability and ROU asset are \$805,114 and \$750,556, respectively.
- ▶ Retailer Co. remeasures the lease liability to \$929,309 as follows:

|         | PMT      | Interest<br>(6%) | Principal<br>Amort. | Closing<br>balance |
|---------|----------|------------------|---------------------|--------------------|
| Year 3  | -130,250 | 55,759           | -74,491             | 854,818            |
| Year 4  | -135,763 | 51,289           | -84,473             | 770,345            |
| Year 5  | -141,551 | 46,221           | -95,330             | 675,015            |
| Year 6  | -147,628 | 40,501           | -107,127            | 567,887            |
| Year 7  | -154,010 | 34,073           | -119,936            | 447,951            |
| Year 8  | -160,710 | 26,877           | -133,833            | 314,118            |
| Year 9  | -167,746 | 18,847           | -148,898            | 165,220            |
| Year 10 | -175,133 | 9,913            | -165,220            | —                  |

Undiscounted PMTs **-1,212,789**

**PV(6%)= -929,309**

- This results in an increase to the lease liability of \$124,195 (\$929,309 - 805,114). The amount of the remeasurement is recognized as an adjustment to the ROU asset.

| \$                 | \$      |
|--------------------|---------|
| Right-of-use asset | 124,195 |
| Lease liability    | 124,195 |

- The updated balance of the right-of-use asset is therefore \$874,751 (\$750,556 + \$124,195).  
 ► Because the lease liability was remeasured, Retailer Co. updates the periodic lease cost for the remainder of the lease term (8 years):

|   |                     |
|---|---------------------|
| Total lease payments (paid and not yet paid)*           | \$ 1,387,789        |
| Plus, initial direct costs                              | 20,000              |
| Less, periodic lease cost recognized in prior periods** | <u>(249,558)</u>    |
| Total remaining lease cost [A]                          | <u>\$ 1,158,231</u> |
| <b>Periodic lease cost [B] = [A] / 8y</b>               | <b>\$ 144,779</b>   |

\* This amount reflects the total revised lease payments. It includes those paid in Year 1 of \$100,000 and Year 2 of \$105,000, plus the revised lease payments for the remaining lease term of \$1,212,789, less the lease incentive received at commencement of \$(30,000).

\*\* Represents prior periodic lease cost of \$124,779 x 2 years (See Example 6.2)

- Following the remeasurement, Retailer Co. recognizes a single lease expense of \$144,779 each year for the remainder of the lease term assuming no impairment, modifications, or other reassessments.  
 ► The accounting for the right-of-use asset after the remeasurement, and throughout the lease term (assuming no impairment, modifications, or other reassessments) can be determined as follows:

|         | Opening<br>balance | Periodic<br>lease cost | Interest<br>(6%) | Amortization    | Closing<br>balance |
|---------|--------------------|------------------------|------------------|-----------------|--------------------|
|         | [A]                | [B]                    | [C]              | [D] = [B] + [C] | [A] + [D]          |
| Year 3  | 874,751            | -144,779               | 55,759           | -89,020         | 785,730            |
| Year 4  | 785,730            | -144,779               | 51,289           | -93,490         | 692,240            |
| Year 5  | 692,240            | -144,779               | 46,221           | -98,558         | 593,682            |
| Year 6  | 593,682            | -144,779               | 40,501           | -104,278        | 489,404            |
| Year 7  | 489,404            | -144,779               | 34,073           | -110,706        | 378,698            |
| Year 8  | 378,698            | -144,779               | 26,877           | -117,902        | 260,797            |
| Year 9  | 260,797            | -144,779               | 18,847           | -125,932        | 134,865            |
| Year 10 | 134,865            | -144,779               | 9,913            | -134,865        | —                  |

### 5.7.3 Variable Lease Payments That Depend on an Index or a Rate

As discussed in Chapter 4, variable lease payments that depend on an index or a rate are included in the lease payments and are initially measured using the index or rate at the commencement date. Other variable payments (for example, those based on sales of the lessee) typically are not included in the lease payments.

Subsequent changes in the index or rate do not represent the resolution of a contingency and, therefore, absent another event requiring remeasurement of the lease payments, the amounts resulting from the difference between the index or rate at commencement and subsequent changes are recognized as variable lease payments. Variable lease payments based on an index or a rate are remeasured only when the lessee remeasures the lease payments for another reason (for example, when there is a change in the lease term) and, if so, are remeasured using the index or rate at the remeasurement date. The FASB considered, but rejected, an approach in IFRS 16, *Leases* in which the lessee remeasures the lease payments when there is a change in the cash flows (when the adjustment to the lease payments takes effect).

The following table summarizes the accounting for variable lease payments based on an index or a rate under ASC 842:

#### ACCOUNTING UNDER ASC 842

- ▶ Variable lease payments based on an index or a rate are not remeasured after the commencement date, and subsequent changes in the index or rate are recognized as variable lease payments, unless the lessee remeasures the lease payments for another reason.
- ▶ When lease payments are remeasured for another reason (for example, when there is a change in the lease term), a lessee remeasures variable lease payments that depend on an index or a rate using the index or rate at the remeasurement date.
- ▶ A lessee updates the discount rate if the lease payments are remeasured because of (a) a modification not accounted for as a separate contract, or (b) a change in the lease term or the assessment of a purchase option.

However, certain lease contracts may include payments based on an index or a rate subject to a floor, cap or other variable such as a significant leverage. In those situations, the lessee should include in the lease payments the amounts that are unavoidable, such as amounts subject to a floor or that represent in-substance fixed payments because they lack genuine variability. The lessee may also be required to evaluate whether the inflation-indexed feature requires bifurcation under derivative accounting. See Section 4.4 for further discussion.

**EXAMPLE 6.5 - REMEASUREMENT OF VARIABLE LEASE PAYMENTS THAT DEPEND ON AN INDEX OR A RATE****FACTS**

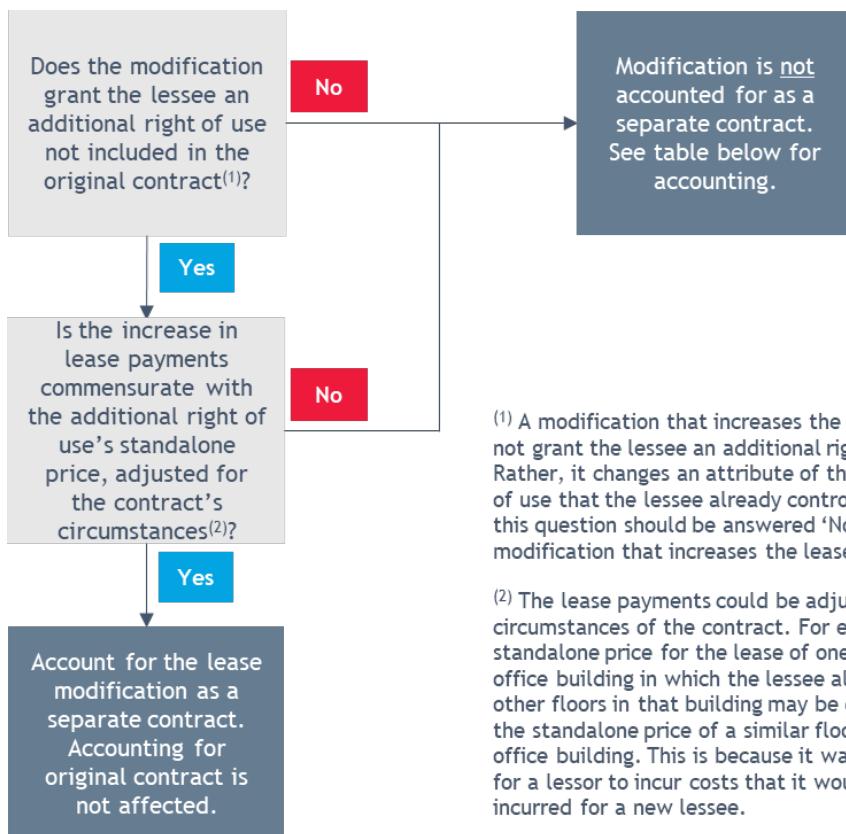
- ▶ Assume Retailer Co. entered into another lease of retail space with the following terms:
  - The noncancelable period of the lease is five years, and Retailer Co. has an option to renew the term for an additional five years.
  - At the commencement date, Retailer Co. determines it is not reasonably certain to exercise the renewal option. Accordingly, the lease term at the commencement date is five years.
  - Annual lease payments are \$100,000, payable at the beginning of each year.
  - Lease payments for each year will increase based on the increase in the Consumer Price Index (CPI) for the preceding 12 months.
  - The lease is classified as an operating lease.
  - There are no nonlease components.
- ▶ Retailer Co. paid \$20,000 of initial direct costs and received at the commencement date a lease incentive of \$30,000.
- ▶ The rate implicit in the lease is not readily determinable. Therefore, Retailer Co. uses its incremental borrowing rate, which is 7% at the commencement date.
- ▶ Assume that at the end of the first year of the lease, CPI has increased by 2%.

**ANALYSIS**

- ▶ The initial measurement of the lease liability after the first payment is \$338,721 (present value of four payments of \$100,000 due at the beginning of Years 2 to 5, discounted at 7%).
- ▶ The initial measurement of the right-of-use asset is \$428,721 (amount of lease liability of \$338,721, plus lease prepayment of \$100,000, plus initial direct costs of \$20,000, less lease incentive of \$30,000).
- ▶ In Year 1, Retailer Co. recognizes a single lease cost of \$98,000 (the total lease payments of \$470,000 [\$500,000 - lease incentive of \$30,000], plus initial direct costs of \$20,000 equals total lease costs of \$490,000, which is divided by the lease term of five years).
- ▶ If Retailer Co. is not required to remeasure the lease liability for another reason, Retailer Co. does not make an adjustment to the lease liability to reflect the increase in payments due to the increase in CPI at the end of the reporting period. In other words, the measurement of the lease liability continues to reflect annual lease payments of \$100,000.
- ▶ For example, the Year 2 payment amount is \$102,000. However, the \$100,000 annual fixed payment continues to be recognized as a reduction in the lease liability, while the \$2,000 variable lease payment will be recognized in profit or loss for Year 2 of the lease along with the single lease cost of \$98,000. The lease liability is not remeasured.

## 5.8 MODIFICATIONS

A lease modification is a change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease (for example, a change to the terms of the contract that adds or terminates the right to use one or more underlying assets or extends or shortens the contractual lease term). Modifications only include changes to the terms and conditions that did not exist in the original contract. For example, the exercise of an option that was included in the original lease does not constitute a modification. Lessees are required to account for modifications at the date that the lease modification is approved by the lessee and the lessor, which is the effective date of the modification under ASC 842. ASC 842 differentiates between modifications that result in a separate contract and which therefore do not affect the accounting for the original contract, and other modifications that should be accounted for as part of the original contract. That determination can be made by using the following steps:



<sup>(1)</sup> A modification that increases the lease term does not grant the lessee an additional right-of-use. Rather, it changes an attribute of the original right of use that the lessee already controls. Accordingly, this question should be answered 'No' for a modification that increases the lease term.

<sup>(2)</sup> The lease payments could be adjusted for the circumstances of the contract. For example, the standalone price for the lease of one floor of an office building in which the lessee already leases other floors in that building may be different from the standalone price of a similar floor in a different office building. This is because it was not necessary for a lessor to incur costs that it would have incurred for a new lessee.



### RELIEF IS PROVIDED FOR REFERENCE RATE REFORM

ASU 2020-04 provides entities with optional expedients and exceptions for applying U.S. GAAP to contracts and transactions affected by the reference rate reform (i.e. discontinuation of LIBOR or similar reference rates expected to be discontinued). Accordingly, modifications to contracts within the scope of ASC 842 may be accounted for as a continuation of the existing contract. That is, the change in reference rate is treated as variable lease payments that were based on the reference rate in the original lease. However, to qualify for the optional expedient, other terms being concurrently modified, if any, must be related to the replacement of a reference rate because of reference rate reform. For example, changes to the contractual term of the lease, additions or terminations of right-to-use underlying assets, changes to renewal, termination or purchase options are deemed unrelated to the replacement of a reference rate and, therefore, are not eligible for the expedient. See ASC 848-20-15-2 through 15-6 for additional information about scope of the expedient, and ASC 848-20-35-11 through 35-13 for application of the expedient to leases.

If a modification is **not** accounted for as a separate contract, the lessee accounts for the modification as follows at the modification's effective date:

| MODIFICATION   | GENERAL ACCOUNTING  | ADDITIONAL GUIDANCE   |
|--|---|---|
| Grants the lessee an additional right-of-use not included in the original contract and the lease payments are not commensurate with standalone price | <ul style="list-style-type: none"> <li>▶ Remeasure the lease payments and the consideration in the contract,</li> <li>▶ Reallocate the remaining consideration to the lease and nonlease components (unless the practical expedient to not separate is elected),</li> <li>▶ Update the discount rate for the lease,</li> <li>▶ Remeasure the lease liability, and</li> <li>▶ Reassess lease classification and update the subsequent accounting for the lease accordingly.</li> </ul> | <ul style="list-style-type: none"> <li>▶ Recognize the remeasurement amount of the lease liability as an adjustment to the right-of-use asset.</li> <li>▶ However, if the carrying amount of the right-of-use asset is reduced to zero, the remaining amount is generally recognized in profit or loss.</li> </ul>  |
| Extends or reduces the term of an existing lease, other than through exercise of an option in the original contract                                  |   |   |
| Changes the consideration in the contract only   |   |   |
| Fully or partially terminates an existing lease (for example, reduces the assets subject to the lease)   |   | <ul style="list-style-type: none"> <li>▶ Decrease the carrying amount of the ROU asset on a basis proportionate to the full or partial termination. Any difference between the reduction in lease liability and proportionate reduction in ROU asset is recognized as a gain or loss at the modification's effective date.</li> <li>▶ ASC 842 provides two acceptable methods for determining the proportional reduction in the ROU asset (see illustration in Example 6.9).</li> </ul> |

It is also important to note that if a finance lease is modified and the modified lease is classified as an operating lease, any difference between the adjusted carrying amount of the right-of-use asset and the carrying amount of the right-of-use asset that would result from applying the initial operating right-of-use asset measurement guidance to the modified lease should be accounted for as a rent prepayment or lease incentive (see Example 6.8B).



#### FULL OR PARTIAL TERMINATION GUIDANCE APPLIES ONLY TO IMMEDIATE TERMINATIONS

The guidance related to full or partial terminations in the above table applies only if the right of use or a portion thereof **immediately ceases** at the effective date of the modification (for example, the lessee immediately returns the leased asset or immediately vacates leased office space). If a lessee and a lessor execute an amendment to fully or partially terminate the lease but the change is effective only after a period of time or upon the occurrence of a specified event, the lessee should apply the guidance on lease term reductions rather than the guidance on terminations.



#### MODIFICATIONS THAT ARE NOT A SEPARATE CONTRACT ARE ACCOUNTED LIKE NEW LEASES

When a modification is not accounted for as a separate contract, the lessee remeasures the lease liability for the modified, existing lease as of the modification's effective date as if the modified lease were a new lease that commenced on that date. Therefore, the lessee reassesses lease classification and remeasures the right-of-use asset and the lease liability based on the changed terms and conditions of the modified contract (including the changed lease payments).

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

#### BDO INSIGHTS – MODIFICATION CONSIDERATIONS FOR MASTER LEASE AGREEMENTS

Master lease agreements typically provide a lessee with the right to use multiple underlying assets. If a master lease agreement permits the lessee to gain control over the use of additional underlying assets during the contract's term but does not obligate the lessee to do so, when the lessee takes control over the use of an additional asset it should be accounted for as a lease modification as described above.

In contrast, a master lease agreement that specifies a minimum number of units or dollar value of equipment does not result in a lease modification when the lessee obtains control over the use of those additional assets. Rather, there may be separate lease components in the contract, and potentially multiple commencement dates. In those situations, the lessee should allocate the consideration in the contract to the various lease components and nonlease components (if applicable), recognize the related lease components on balance sheet at the commencement date and disclose the forward starting leases for the lease components that have not yet commenced.

A lessee and a lessor may also modify a master lease agreement to early terminate the right to use some of the assets (lease components) in the master lease agreement. Even if the modification does not change the economics of the remaining lease components, the lessee should apply modification accounting, including reassessing classification and adjusting the accounting for the remaining lease components. This requires the lessee to reconsider inputs for classification and measurement purposes, such as the economic life and fair value of the underlying assets and the discount rate for the lease. In 2020, the FASB proposed changes to the modification guidance following stakeholder feedback questioning the usefulness and costs of applying modification accounting to modifications reducing the scope of certain arrangements, such as master lease agreements. However, the FASB later abandoned the project and, accordingly, the guidance remains unchanged.

**BDO INSIGHTS – MODIFICATIONS RELATED TO VARIABLE LEASE PAYMENTS THAT ARE NOT BASED ON AN INDEX OR A RATE**

Variable lease payments that are not based on an index or a rate, such as payments based on a percentage of sales of the lessee, are excluded from the definition of lease payments and thus excluded from the consideration in the contract under ASC 842. Therefore, those payments are not included in the measurement of the lease on balance sheet. However, if the lessee and lessor modify the agreement to change such payments, such as by lowering the percentage applied to sales of the lessee or to add variable lease payments not based on an index or a rate, we believe the lessee should apply the modification framework described above. The lease modification guidance under ASC 842 is not limited to changes in the *consideration in the contract* (as defined in ASC 842), but rather applies more broadly to **any** changes in the consideration for a lease. In other words, any modification that results in changes in the payments required by the lease, whether those payments meet the definition of lease payments or not, should be evaluated under the modification guidance previously discussed.

### EXAMPLE 6.6 - MODIFICATION IS ACCOUNTED FOR AS A SEPARATE LEASE

#### FACTS

- ▶ Assume the same facts as in Examples 6 and 6.2 apply, in which the lease of the retail space is an operating lease. Also assume the following:
  - At the end of Year 5 of the lease, Retailer Co. and the lessor agree to modify the contract to include an additional 9,000 square feet of retail space in an adjacent building for the remaining 5 years of the original 10-year lease term. No costs are incurred with the modification.
  - The additional space is made available for use by Retailer Co. at the beginning of Year 6.
  - The annual lease payments in Years 6-10 increase by \$140,000, payable in arrears.
  - Retailer Co.'s incremental borrowing rate at the effective date of the modification is 7%.

#### ANALYSIS

- ▶ Retailer Co. notes that the modification grants it an additional right-of-use not included in the original contract. Retailer Co. also assesses the corresponding increase in lease payments and determines that the increase is commensurate with the market lease rate for similar space at the modification date. Retailer Co. therefore concludes that the modification should be accounted for as a separate contract.
- ▶ This means that the accounting for the original 10-year lease of 10,000 square feet is not affected by the modification (see Example 6.2 for the accounting).
- ▶ Retailer Co. determines that the separate lease is an operating lease.
- ▶ The accounting for the lease liability for the new 9,000 square feet of retail space lease is as follows:

|                 | PMT            | Interest<br>(7%) | Principal<br>Amort. | Closing<br>balance |
|-----------------|----------------|------------------|---------------------|--------------------|
| Year 1          | -140,000       | 40,182           | -99,818             | 474,210            |
| Year 2          | -140,000       | 33,195           | -106,805            | 367,404            |
| Year 3          | -140,000       | 25,718           | -114,282            | 253,123            |
| Year 4          | -140,000       | 17,719           | -122,281            | 130,841            |
| Year 5          | -140,000       | 9,159            | -130,841            | 0                  |
| <b>PV(7%) =</b> | <b>574,028</b> |                  |                     |                    |

- ▶ Retailer Co. initially measures the ROU asset at the same amount as the lease liability (since there are no initial direct costs, or lease incentives received, for the additional right-of-use).

|                    | \$      | \$      |
|--------------------|---------|---------|
| Right-of-use asset | 574,028 |         |
| Lease liability    |         | 574,028 |

- ▶ Retailer Co. accounts for the right-of-use asset as follows, assuming no impairment and remeasurements.

|        | Opening<br>balance<br><br>[A] | Periodic<br>lease cost<br><br>[B] | Interest (7%)<br><br>[C] | Amortization<br><br>[D] = [B] + [C] | Closing<br>balance<br><br>[A] + [D] |
|--------|-------------------------------|-----------------------------------|--------------------------|-------------------------------------|-------------------------------------|
|        |                               |                                   |                          |                                     |                                     |
| Year 1 | 574,028                       | -140,000                          | 40,182                   | -99,818                             | 474,210                             |
| Year 2 | 474,210                       | -140,000                          | 33,195                   | -106,805                            | 367,404                             |
| Year 3 | 367,404                       | -140,000                          | 25,718                   | -114,282                            | 253,123                             |
| Year 4 | 253,123                       | -140,000                          | 17,719                   | -122,281                            | 130,841                             |
| Year 5 | 130,841                       | -140,000                          | 9,159                    | -130,841                            | —                                   |

**EXAMPLE 6.7 - MODIFICATION IS NOT ACCOUNTED FOR AS A SEPARATE LEASE - LEASE CLASSIFICATION UNCHANGED**

**FACTS**

- ▶ Assume the same facts as in Examples 6 and 6.2 apply in which Retailer Co.'s lease of retail space is classified as an operating lease. Also assume the following:
  - At the beginning of Year 6, Retailer Co. and the lessor agree to extend the term of the lease by 5 years for fixed annual lease payments of \$140,000.
  - At the beginning of Year 6, the carrying amount of the lease liability and right-of-use assets are \$590,767 and \$509,436, respectively.
  - Retailer Co.'s incremental borrowing rate at the effective date of the modification is 7%.

**ANALYSIS**

- ▶ The modification does not grant Retailer Co. an additional right of use. It merely changes an attribute of the original lease by extending the period of use for the original ROU asset. That is, Retailer Co. still controls only a single right of use it received at lease commencement.
- ▶ Therefore, the modification cannot be accounted for as a separate contract.
- ▶ At the effective date of the modification, Retailer Co. reassesses lease classification using the revised lease term and lease payments, remaining economic life, current fair value and updated discount rate, and concludes that it continues to be an operating lease.
- ▶ Retailer Co. remeasures the lease liability based on the remaining 10-year lease term and 10 remaining payments using its incremental borrowing rate at the modification date of 7%.

|                | PMT      | Interest<br>(7%) | Principal<br>Amort. | Closing<br>Balance |
|----------------|----------|------------------|---------------------|--------------------|
| Year 6         | -127,628 | 68,865           | -58,763             | 925,022            |
| Year 7         | -134,010 | 64,752           | -69,258             | 855,764            |
| Year 8         | -140,710 | 59,903           | -80,807             | 774,957            |
| Year 9         | -147,746 | 54,247           | -93,499             | 681,458            |
| Year 10        | -155,133 | 47,702           | -107,431            | 574,028            |
| Year 11        | -140,000 | 40,182           | -99,818             | 474,210            |
| Year 12        | -140,000 | 33,195           | -106,805            | 367,404            |
| Year 13        | -140,000 | 25,718           | -114,282            | 253,123            |
| Year 14        | -140,000 | 17,719           | -122,281            | 130,841            |
| Year 15        | -140,000 | 9,159            | -130,841            | —                  |
| <b>PV(7%)=</b> |          | <b>983,785</b>   |                     |                    |

- ▶ Consequently, the modified lease liability equals \$983,785 (or an increase of \$393,017).
- ▶ The increase to the lease liability is recorded as an adjustment to the right-of-use asset (that is, there is no income or loss recognized at the modification date). The updated balance of the right-of-use asset is \$902,453 (\$509,436 + \$393,017).
- ▶ Retailer Co. updates the periodic lease cost for the remainder of the lease (10 years):

|   |                     |
|---|---------------------|
| Total lease payments (paid and not yet paid)*           | \$ 1,927,789        |
| Plus, initial direct costs                              | 20,000              |
| Less, periodic lease cost recognized in prior periods** | <u>(623,895)</u>    |
| Total remaining lease cost [A]                          | <u>\$ 1,323,894</u> |
| <b>Periodic lease cost [B] = [A] / 10y</b>              | <b>\$ 132,389</b>   |

\* This amount reflects the total revised lease payments. It includes those paid in Years 1 - 5, the revised lease payments for the remaining lease term, less the lease incentive received at commencement date of \$30,000.

\*\* Represents period lease cost of \$124,779 for 5 years.

- ▶ Retailer Co. recognizes annual straight-line lease expense of \$132,389 for the remainder of the lease term.
- ▶ The accounting for the ROU asset after the remeasurement is summarized in the following table, assuming no impairment and remeasurements:

|         | Opening<br>balance | Periodic<br>lease cost | Interest on<br>lease liability | Amortization | Ending<br>Balance            |
|---------|--------------------|------------------------|--------------------------------|--------------|------------------------------|
|         |                    |                        |                                |              | [D] = [B] + [C]<br>[A] + [D] |
|         | [A]                | [B]                    | [C]                            | [D]          |                              |
| Year 6  | 902,453            | -132,389               | 68,865                         | -63,525      | 838,929                      |
| Year 7  | 838,929            | -132,389               | 64,752                         | -67,638      | 771,291                      |
| Year 8  | 771,291            | -132,389               | 59,903                         | -72,486      | 698,805                      |
| Year 9  | 698,805            | -132,389               | 54,247                         | -78,142      | 620,662                      |
| Year 10 | 620,662            | -132,389               | 47,702                         | -84,687      | 535,975                      |
| Year 11 | 535,975            | -132,389               | 40,182                         | -92,208      | 443,767                      |
| Year 12 | 443,767            | -132,389               | 33,195                         | -99,195      | 344,573                      |
| Year 13 | 344,573            | -132,389               | 25,718                         | -106,671     | 237,901                      |
| Year 14 | 237,901            | -132,389               | 17,719                         | -114,671     | 123,231                      |
| Year 15 | 123,231            | -132,389               | 9,159                          | -123,231     | —                            |

**EXAMPLE 6.8A - MODIFICATION IS NOT ACCOUNTED FOR AS A SEPARATE LEASE - LEASE CLASSIFICATION CHANGES FROM OPERATING TO FINANCE****FACTS**

- ▶ Assume the same facts as in Example 6.7 above apply, except that at the effective date of the modification, Retailer Co. concludes that lease classification changes from operating to finance.

**ANALYSIS**

- ▶ The assessment of the modification is the same as in Example 6.7, and therefore the modification cannot be accounted for as a separate contract.
- ▶ The remeasurement of the lease liability and adjustment to the ROU asset is also the same as in Example 6.7. That is, after the remeasurement, the carrying value of the lease liability and ROU asset are \$983,785 and \$902,453, respectively.
- ▶ However, unlike Example 6.7, Retailer Co. does not calculate the updated straight-line lease expense. Instead, as of the effective date of the lease modification, the ROU asset is amortized on a straight-line basis to the earlier of the end of the underlying asset's useful life or lease term. However, If the lease transfers ownership of the underlying asset to the lessee or the lessee is reasonably certain to exercise a purchase option, the lessee amortizes the right-of-use asset to the end of the asset's useful life.

**EXAMPLE 6.8B - MODIFICATION IS NOT ACCOUNTED FOR AS A SEPARATE LEASE - LEASE CLASSIFICATION CHANGES FROM FINANCE TO OPERATING****FACTS**

- ▶ Assume the same facts as in Examples 6 and 6.1 apply, in which Retailer Co.'s lease of manufacturing equipment was a finance lease. Also assume the following:
  - At the beginning of Year 6, Retailer Co. and the lessor agree to modify the lease to reduce the remaining lease term by two years and for revised annual lease payments of \$130,000 for the remaining three years of the lease.
  - At the beginning of Year 6, the carrying amount of the lease liability and right-of-use assets are \$590,767 and \$447,169 ( $894,337 \times [5/10]$ ), respectively.
  - Retailer Co.'s incremental borrowing rate at the effective date of the modification is 7%.

## ANALYSIS

- ▶ The modification reduces the term of the lease, and the term is an attribute of the lease. Therefore, the modification cannot be accounted for as a separate contract and Retailer applies ASC 842-10-25-11(b).
- ▶ Retailer Co. remeasures the lease liability based on the remaining 3-year lease term, 3 remaining payments using its incremental borrowing rate at the modification date of 7%.

|         | PMT            | Interest<br>(7%) | Principal<br>Amort. | Closing<br>Balance |
|---------|----------------|------------------|---------------------|--------------------|
| Year 6  | -130,000       | 23,881           | -106,119            | 235,042            |
| Year 7  | -130,000       | 16,453           | -113,547            | 121,495            |
| Year 8  | -130,000       | 8,505            | -121,495            | —                  |
| PV(7%)= | <b>341,161</b> |                  |                     |                    |

- ▶ Consequently, the remeasured lease liability equals \$341,161 (or a decrease of \$249,606).
- ▶ The decrease in lease liability is recorded as an adjustment to the ROU asset (that is, there is no income or loss recognized at the modification date). The updated balance of the right-of-use asset is \$197,562.
- ▶ Retailer Co. accounts for the lease at the modification date as an operating lease; e.g. the revised lease term is not for the major part of the remaining economic life of the underlying asset ( $3/7 = 42.86\%$ ). Accordingly, Retailer Co. will record a single lease cost over the remaining lease term (3 years).
- ▶ In addition, in accordance with ASC 842-10-25-14, Retailer Co. accounts for the difference between the updated carrying amount of the ROU asset and the carrying amount of the ROU asset that would result from applying the initial measurement guidance for operating ROU assets, as either a rent prepayment or a lease incentive. Retailer Co. calculates that amount as follows:

|                                      |                            |
|--------------------------------------|----------------------------|
| Updated ROU asset carrying amount    | \$ 197,562                 |
| ROU operating lease carrying amount* | <u>341,161</u>             |
| <b>Lease incentive</b>               | <b><u>\$ (143,599)</u></b> |

\* This amount represents the amount of the lease liability after remeasurement. There are no initial direct costs or lease incentives for the modification and, therefore, no further adjustments under ASC 842-20-30-5.

- ▶ Next, Retailer Co. calculates the remaining cost for the lease as follows\*:

|   |                   |
|---|-------------------|
| Sum of remaining lease payments**           | \$ 390,000        |
| Less, lease incentive adjustment from above | <u>(143,599)</u>  |
| Total remaining lease cost [A]              | <u>\$ 246,401</u> |
| <b>Periodic lease cost [B] = [A] / 3y</b>   | <b>\$ 82,134</b>  |

\* Approach illustrated is based on application of ASC 842-10-25-14. Alternatively, Retailer Co. could determine the remaining lease cost by applying ASC 842-20-25-8. In doing so, the lease incentive calculated above of \$143,599 would not be included under ASC 842-20-25-8(a) (it only relates to application of the method described in ASC 842-10-25-14), and the periodic lease cost previously recognized under ASC 842-20-25-8(c) would be determined as the sum of periodic interest and amortization of the ROU asset. Regardless of the approach selected, the total remaining lease cost should be the same.

\*\* This amount reflects the remaining (modified) lease payments (\$130,000 x 3 years).

- ▶ Retailer Co. recognizes annual straight-line lease expense of \$82,134 for the remainder of the lease term.

- The accounting for the ROU asset after the remeasurement is summarized in the following table:

|        | Opening balance<br>[A] | Periodic lease cost<br>[B] | Interest on lease liability<br>[C] | Amortization<br>[D] = [B] + [C] | Ending Balance<br>[A] + [D] |
|--------|------------------------|----------------------------|------------------------------------|---------------------------------|-----------------------------|
| Year 6 | 197,562                | -82,134                    | 23,881                             | -58,253                         | 139,310                     |
| Year 7 | 139,310                | -82,134                    | 16,453                             | -65,681                         | 73,629                      |
| Year 8 | 73,629                 | -82,134                    | 8,505                              | -73,629                         | —                           |

#### EXAMPLE 6.9A - MODIFICATION IS NOT ACCOUNTED AS A SEPARATE LEASE - PARTIAL TERMINATION

##### FACTS

- Assume the same facts as in Examples 6 and 6.2 apply, in which the lease is an operating lease. Also assume the following:
- At the beginning of Year 6 of the lease, Retailer Co. and the lessor agree to modify the original lease for the remaining 5 years to immediately reduce the leased retail space to only 5,000 square feet. In addition, the annual lease payments in Years 6-10 are reduced to \$65,000.
  - At the beginning of Year 6, the carrying amount of the lease liability and right-of-use assets are \$590,767 and \$509,436, respectively.
  - Retailer Co.'s incremental borrowing rate at the effective date of the modification is 7%.

##### ANALYSIS

- Retailer Co. concludes that the modification should not be accounted for as a separate contract, as it does not grant Retailer Co. an additional right of use but rather decreases the original scope of the lease (from 10,000 square feet to 5,000 square feet).
- At the effective date of the modification, Retailer Co. reassesses lease classification and concludes that the lease continues to be an operating lease.
- Retailer Co. remeasures the lease liability based on the remaining 5-year lease term and discounts the remaining payments using its incremental borrowing rate at that date.

|         | PMT     | Interest<br>(7%) | Principal<br>Amort. | Closing<br>Balance |
|---------|---------|------------------|---------------------|--------------------|
| Year 6  | -65,000 | 18,656           | -46,344             | 220,169            |
| Year 7  | -65,000 | 15,412           | -49,588             | 170,581            |
| Year 8  | -65,000 | 11,941           | -53,059             | 117,521            |
| Year 9  | -65,000 | 8,226            | -56,774             | 60,748             |
| Year 10 | -65,000 | 4,252            | -60,748             | —                  |
| PV(7%)= | 266,513 |                  |                     |                    |

- The carrying amount of the right-of-use asset is determined using either of the following approaches:

| Method A - Remeasuring the ROU asset based on the change in lease liability   |                  | Method B - Remeasuring the ROU asset based on the remaining right-of-use   |           |
|---|------------------|--|-----------|
| Lease liability after modification  | 266,513          | Reduction in ROU $(5,000)/10,000\text{SF} =$   | (50.00)%  |
| Lease liability before modification   | <u>(590,767)</u> | Pre-modification ROU asset   | 509,436   |
| Remeasurement adjustment  | (324,254)        | Percentage of change in ROU  | (50.00)%  |
| Percentage change in liability  | (54.89)%         | Reduction to ROU asset   | (254,718) |
|   |                  |  |           |
| Pre-modification ROU asset:   | 509,436          | Pre-modification lease liability   | 590,767   |
| Percentage of change in liability   | (54.89)%         | Percentage of change in ROU  | (50.00)%  |
| Reduction ROU asset   | (279,614)        | Reduction to lease liability   | (295,384) |
|   | \$               |  | \$        |
| Lease liability   | 324,254          | Lease liability  | 295,384   |
| Other income/gain   | 44,640           | Other income/gain  | 40,666    |
| Right-of-use asset  | 279,614          | Right-of-use asset   | 254,718   |
|   |                  | The difference between the remeasurement of the lease liability of \$266,513 (reflecting the revised lease payments and updated discount rate) and the remaining lease liability of \$295,383 ( $590,767 - 295,384$ ) after the above journal entry is recorded as an adjustment to the ROU asset: |           |
|   |                  |  | \$        |
|   |                  | Lease liability  | 28,870    |
|   |                  | Right-of-use asset   | 28,870    |
| The updated balance of the lease liability and of the right-of-use asset after the above journal entry are \$266,513 and \$229,822, respectively. |                  | The updated balance of the lease liability and of the right-of-use asset after the above journal entries are \$266,513 and \$225,848, respectively.  |           |

► Retailer Co. then updates the periodic lease cost for the remainder of the lease (10 years):

If Method A (change in lease liability) was used

|  |                   |
|--|-------------------|
| Total lease payments (paid and not yet paid)*            | \$ 560,744        |
| Plus, initial direct costs**                             | 9,023             |
| Less, periodic lease cost recognized in prior periods*** | (281,458)         |
| Total remaining lease cost [A]                           | <u>\$ 288,309</u> |
| <b>Periodic lease cost [B] = [A] / 5y</b>                | <b>\$ 57,662</b>  |

\* This amount reflects the total revised lease payments. It includes the relative portion (100% - 54.89% reduction in ROU = 45.11%) after remeasurement of the payments paid in Years 1-5 ( $552,563 * 45.11\% = \$249,278$ ), plus the revised lease payments for the remaining lease term (\$325,000), less the relative balance of the lease incentive received at commencement date of \$13,534 ( $\$30,000 * 45.11\%$ ).

\*\* Represents the relative portion of the initial direct costs after remeasurement ( $\$20,000 * 45.11\%$ )

\*\*\* Represents the relative portion of the periodic lease cost recognized in Years 1-5 ( $\$124,779 * 45.11\% * 5$ ).

|         | Opening<br>balance<br>[A] | Periodic<br>lease cost<br>[B] | Interest on<br>lease liability<br>[C] | ROU<br>Amortization<br>[D] = [B] + [C] | Ending<br>Balance<br>[A] + [D] |
|---------|---------------------------|-------------------------------|---------------------------------------|--|--------------------------------|
| Year 6  | 229,822                   | -57,662                       | 18,656                                | -39,006                                | 190,816                        |
| Year 7  | 190,816                   | -57,662                       | 15,412                                | -42,250                                | 148,566                        |
| Year 8  | 148,566                   | -57,662                       | 11,941                                | -45,721                                | 102,845                        |
| Year 9  | 102,845                   | -57,662                       | 8,226                                 | -49,435                                | 53,410                         |
| Year 10 | 53,410                    | -57,662                       | 4,252                                 | -53,410                                | —                              |
|         |                           |                               | <u>58,487</u>                         |  |                                |

Note: Retailer Co. could also have determined the remaining lease cost based on the updated ROU asset of \$229,822, plus the sum of periodic interest accretion in Years 6-10 of \$58,487 (per above table), which equals \$288,309, or an annual lease cost of \$57,662. This could be used as an independent recalculation of the remaining lease cost for accuracy purposes.

If Method B (Percentage of the remaining right of use) was used

|  |                   |
|--|-------------------|
| Total lease payments (paid and not yet paid)*            | \$ 586,282        |
| Plus, initial direct costs**                             | 10,000            |
| Less, periodic lease cost recognized in prior periods*** | (311,947)         |
| Total remaining lease cost [A]                           | <u>\$ 284,335</u> |
| <b>Periodic lease cost [B] = [A] / 5y</b>                | <b>\$ 56,867</b>  |

\* This amount reflects the total revised lease payments. It includes the relative portion (100% - 50.00% reduction in ROU = 50.00%) after remeasurement of the payments paid in Years 1-5 ( $552,563 * 50\% = \$276,282$ ), plus the revised lease payments for the remaining lease term (\$325,000), less the relative balance of the lease incentive received at commencement date of \$15,000 ( $\$30,000 * 50\%$ ).

\*\* Represents the relative portion of the initial direct costs after remeasurement ( $\$20,000 * 50\%$ ).

\*\*\* Represents the relative portion of the periodic lease cost recognized in Years 1-5 ( $\$124,779 * 50\% * 5$ ).

|         | Opening balance<br>[A] | Periodic lease cost<br>[B] | Interest on lease liability<br>[C] | ROU Amortization<br>[D] = [B] + [C] | Ending Balance<br>[A] + [D] |
|---------|------------------------|----------------------------|------------------------------------|-------------------------------------|-----------------------------|
| Year 6  | 225,848                | -56,867                    | 18,656                             | -38,211                             | 187,637                     |
| Year 7  | 187,637                | -56,867                    | 15,412                             | -41,455                             | 146,182                     |
| Year 8  | 146,182                | -56,867                    | 11,941                             | -44,926                             | 101,255                     |
| Year 9  | 101,255                | -56,867                    | 8,226                              | -48,640                             | 52,615                      |
| Year 10 | 52,615                 | -56,867                    | 4,252                              | -52,615                             | —                           |
|         |                        |                            | <u>58,487</u>                      |                                     |                             |

Note: Retailer Co. could also have determined the remaining lease cost based on the updated ROU asset of \$225,848, plus the sum of periodic interest accretion in Years 6-10 of \$58,487 (per above table), which equals \$284,335, or an annual lease cost of \$56,867. This could be used as an independent recalculation of the remaining lease cost for accuracy purposes.



#### PROPORTIONATE REDUCTION IN ROU ASSET MAY BE CALCULATED USING TWO APPROACHES

Example 18 in ASC 842-10-55-177 through 55-185 provides two different methodologies for determining the proportionate reduction in the right-of-use asset in a partial termination and for calculating the gain or loss on partial termination. We illustrated this accounting in Example 6.9A above. The FASB noted in paragraph BC177 of ASU 2016-02 that both approaches are acceptable to the Board. Consistent with ASC 842-10-10-1, we believe an entity should apply an approach consistently to lease modifications with similar characteristics and in similar circumstances.

**EXAMPLE 6.9B - MODIFICATION IS NOT ACCOUNTED AS A SEPARATE LEASE - PARTIAL TERMINATION AND EXTENSION OF THE LEASE TERM**

**FACTS**

- ▶ Assume the same facts as in Examples 6 and 6.2 apply, in which the lease of the retail space is an operating lease. Also assume the following:
  - At the beginning of Year 6 of the lease, Retailer Co. and the lessor agree to modify the original lease such that the retail space Retailer Co. uses is reduced from 10,000 square feet to 5,000 square feet effective at the modification date, the term of the lease is extended by three years, and lease payments are reset to \$68,000 annually, with a 5% annual increase for the remainder of the revised term.
  - At the beginning of Year 6, the carrying amount of the lease liability and right-of-use asset are \$590,767 and \$509,436, respectively.
  - Retailer Co.'s incremental borrowing rate at the effective date of the modification is 7%.

**ANALYSIS**

- ▶ Retailer Co. concludes that the modification cannot be accounted for as a separate contract, as it does not grant Retailer Co. an additional right of use but rather decreases the original scope of the lease (from 10,000 square feet to 5,000 square feet) and also extends the lease term for the remaining right of use (an attribute of the original lease).
- ▶ Retailer Co. should account for the partial termination and the extension of the term, considering the change in lease payments. To do so, we believe Retailer Co. can first account for the partial termination (in the same manner as in Example 6.9A), and then account for the term extension.
- ▶ Assume Retailer Co. applies Method B described in Example 6.9A (remeasuring the ROU asset based on the remaining right of use).
- ▶ Regardless of the method used to account for the reduction in the ROU asset, the remeasured lease liability after accounting for the partial termination and term extension is the same and is based on the remaining lease term and payments, discounted using Retailer Co.'s incremental borrowing rate at the modification date.

|         | PMT     | Interest<br>(7%) | Principal<br>Amort. | Closing<br>Balance |
|---------|---------|------------------|---------------------|--------------------|
| Year 6  | -68,000 | 33,346           | -34,654             | 441,711            |
| Year 7  | -71,400 | 30,920           | -40,480             | 401,231            |
| Year 8  | -74,970 | 28,086           | -46,884             | 354,347            |
| Year 9  | -78,719 | 24,804           | -53,914             | 300,433            |
| Year 10 | -82,654 | 21,030           | -61,624             | 238,809            |
| Year 11 | -86,787 | 16,717           | -70,071             | 168,738            |
| Year 12 | -91,127 | 11,812           | -79,315             | 89,423             |
| Year 13 | -95,683 | 6,260            | -89,423             | —                  |

**PV(7%)= 476,365**

- Retailer Co. applies the following steps to account for the partial termination and term extension:

Worksheet for partial termination accounting:

|                                     |          |
|-------------------------------------|----------|
| Reduction in ROU (5,000)/10,000SF = | (50.00)% |
|-------------------------------------|----------|

|                            |         |
|----------------------------|---------|
| Pre-modification ROU asset | 509,436 |
|----------------------------|---------|

|                          |          |
|--------------------------|----------|
| Percentage change in ROU | (50.00)% |
|--------------------------|----------|

|                        |           |
|------------------------|-----------|
| Reduction to ROU asset | (254,718) |
|------------------------|-----------|

|                                  |         |
|----------------------------------|---------|
| Pre-modification lease liability | 590,767 |
|----------------------------------|---------|

|                          |          |
|--------------------------|----------|
| Percentage change in ROU | (50.00)% |
|--------------------------|----------|

|                              |           |
|------------------------------|-----------|
| Reduction to lease liability | (295,384) |
|------------------------------|-----------|

|    |    |
|----|----|
| \$ | \$ |
|----|----|

|                 |         |
|-----------------|---------|
| Lease liability | 295,384 |
|-----------------|---------|

|                   |        |
|-------------------|--------|
| Other income/gain | 40,666 |
|-------------------|--------|

|                    |         |
|--------------------|---------|
| Right-of-use asset | 254,718 |
|--------------------|---------|

Worksheet for term extension accounting:

|                                     |            |
|-------------------------------------|------------|
| Lease liability before modification | \$ 590,767 |
|-------------------------------------|------------|

|  |                  |
|--|------------------|
| Partial termination adjustment (journal entry above) | <u>(295,384)</u> |
|--|------------------|

|   |             |
|---|-------------|
| Lease liability balance after partial termination | 295,383 [A] |
|---|-------------|

|   |                    |
|---|--------------------|
| Remeasured lease liability amount (see table above) | <u>476,365</u> [B] |
|---|--------------------|

|                                |                   |
|--------------------------------|-------------------|
| Remaining adjustment [B] - [A] | <u>\$ 180,982</u> |
|--------------------------------|-------------------|

- The difference between the remeasured lease liability of \$476,365 and the lease liability balance after the partial termination entry of \$295,383 is recorded as an adjustment to the ROU asset:

|    |    |
|----|----|
| \$ | \$ |
|----|----|

|                    |         |
|--------------------|---------|
| Right-of-use asset | 180,982 |
|--------------------|---------|

|                 |         |
|-----------------|---------|
| Lease liability | 180,982 |
|-----------------|---------|

- Following the above entries, the carrying amounts of the lease liability and right-of-use asset are \$476,365 and \$435,700, respectively.

## 5.9 IMPAIRMENT

### 5.9.1 General Considerations

The FASB determined that a right-of-use asset is a long-lived nonfinancial asset and, therefore, should be within the scope of the Impairment or Disposal of Long-Lived Assets Subsection of ASC 360. Therefore, right-of-use assets must be monitored for impairment, like other long-lived nonfinancial assets, regardless of whether the lease is an operating lease or a finance lease.

The impairment assessment is performed at the asset group level, which is the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities.

An asset group is tested for impairment when events or changes in circumstances indicate that the asset group may not be recoverable. ASC 360-10-35-21 provides the following examples:

|  |   |   |
|--|---|---|
| A significant decrease in the market price of a long-lived asset (asset group)   | A significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition   | A significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset (asset group), including an adverse action or assessment by a regulator  |
| An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset (asset group) | A current period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset (asset group) | A current expectation that, more likely than not, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life. The term more likely than not refers to a level of likelihood that is more than 50 percent |

When impairment indicators exist, an asset (asset group) should be tested to determine whether there is an impairment. The impairment test is a two-step process as follows:

**Step 1 - Determine if the asset group is recoverable.** To do so, compare (a) the carrying value of the asset group with (b) the undiscounted cash flows expected from the asset group's direct use and eventual disposal. If (a) exceeds (b), the asset group is not recoverable and the entity moves to Step 2.

**Step 2 - Determine the impairment loss.** To do so, determine the asset group's fair value and recognize an impairment loss, if any, for the excess of the asset group's carrying amount over its fair value.

- ▶ The impairment loss reduces only the carrying amounts of a long-lived asset or assets of the group.
- ▶ The impairment loss is allocated to the long-lived assets in the asset group (including ROU assets) on a pro rata basis using the relative carrying amounts of those assets, except that individual long-lived assets cannot be written down below their individual fair values whenever that fair value is determinable without undue cost and effort.

The impairment model under ASC 360-10-35 is not new but the recognition of new right-of-use assets associated with operating leases has resulted in questions about the application of ASC 360.

For finance leases, consistent with capital leases under ASC 840, lease liabilities are excluded when testing an asset group for impairment. This is because debt related to financing of long-lived assets generally is excluded. Because the finance lease liability is excluded from the asset group, the finance lease payments also are excluded when determining the undiscounted cash flows of the asset group.

### 5.9.2 Impairment Assessment for Operating Leases

Because ASC 842 and ASC 360 do not specify whether the related lease liability for operating leases should be included in an asset group for impairment testing purposes, we believe there are multiple acceptable approaches which we summarize in the following table.

|   | APPROACH A                               | APPROACH B   | APPROACH C  |
|---|--|--|---|
| <b>Step 1 - In determining the carrying amount of the asset group:</b>  | <i>Exclude</i> operating lease liability | <i>Include</i> operating lease liability   | <i>Include</i> operating lease liability  |
| <b>Step 1 - In determining the undiscounted cash flows:<sup>a,b</sup></b>   | <i>Exclude</i> lease payments            | <i>Include</i> lease payments but <i>exclude</i> the portion related to interest accretion                 | <i>Include</i> lease payments, with <i>inclusion</i> of the portion related to interest accretion |
| <b>Step 2 - In determining the fair value of the asset group under a discounted cash flow approach:<sup>a,b,c</sup></b> | Same approach as Step 1 above            | Same approach as Step 1, but include <i>total</i> lease payments (since the cash flows will be discounted) | Same approach as Step 1 above   |

Note a - Use entity specific assumptions in Step 1, and market participant assumptions (highest and best use) in Step 2.

Note b - Cash flows include variable lease payments not included in the measurement of the lease liability.

Note c - In allocating the impairment loss to the long-lived assets in the asset group (i.e., the pro rata allocation subject to the individual fair value limitation), consider the right-of-use asset without the lease liability.

We believe each of the above approaches is acceptable because:

- ▶ For Approach A, the operating lease liability is akin to a financial liability and it is measured the same way as finance lease liabilities. Therefore, under that view, the approach under ASC 360 should be the same whether the lease is an operating lease or a finance lease.
- ▶ For Approach B, the lease is classified as an operating lease, and the related liability may be viewed as an operating liability, rather than debt (see paragraph BC14 of ASU 2016-02). Therefore, like other operating liabilities, the operating lease liability is included in determining the carrying amount of the asset group. However, the lease payments should exclude the portion related to interest accretion on the lease liability as it relates to capitalization/ financing of the entity, not its operations.
- ▶ For approach C, this is consistent with approach B, except that the lease payments included in the undiscounted cash flows are the total operating lease payments (because the operating lease cost is recognized as a single lease cost).

Because the different approaches are consistent in how they treat the liability and related cash flows (either both are included or both are excluded), the approach selected generally should not significantly change whether an asset group is impaired, and an entity should select an approach and apply it consistently.

**BDO INSIGHTS – ADDITIONAL COMPLEXITIES RELATED TO APPLICATION OF ASC 360 TO RIGHT-OF-USE ASSETS – ABANDONMENTS AND SUBLLEASES**

As described above, ASC 842 requires an entity to apply the guidance on impairment of long-lived assets in ASC 360 to right-of-use assets. Now that operating leases are recognized on balance sheet, there are additional complexities related to impairment and other standards that an entity will need to consider. For example, after a lease has begun, an entity may consider subleasing or abandoning either the leased asset or a portion of the underlying asset. These may be necessary business decisions, but they will result in additional accounting questions that need to be addressed. Some of those questions include:

**Did the entity appropriately identify its lease components (the unit of account under ASC 842)?**

A lessee may have initially assumed that the unit of account under ASC 842 was a single lease component (for example, one lease component for a lease of multiple floors in an office building). This may have been because the accounting outcome under ASC 842 was the same whether the contract included a single lease component or a lease component for each floor leased. However, entering into a sublease or deciding to abandon a portion of a right-of-use asset raises a unit of account question. Because of the sublease or abandonment, the lessee should determine how many lease components the lease contract includes, as it may for example affect asset groupings under ASC 360, and whether impairment triggers exist, among other aspects.

**Does it affect asset groupings for impairment testing purposes?**

ASC 360 requires an entity to group assets at the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities. There generally is judgment in determining asset groupings, although entering into a sublease will usually result in that asset being deemed its own asset group, as it will generate standalone cash flows from the sublease. A lessee should have processes in place to evaluate whether, and if so, when, asset groupings would change due to sublease and abandonment decisions.

**Is the entity required to test the asset group for impairment?**

Subleasing the underlying asset for the remainder of the lease term is not considered abandoning the asset because the lessee continues to derive economic benefits from use of the asset (through the cash flows on the sublease). However, ASC 842-20-35-14 provides that if a lessee enters into a sublease for which the lease cost for the term of the sublease exceeds the anticipated sublease income for that same period, the original lessee should treat that circumstance as an indicator that the carrying amount of the right-of-use asset associated with the original lease may not be recoverable.

The decision to abandon a right-of-use asset may also be an indicator that an impairment test is required for the asset group, as it represents a significant adverse change in the extent or manner in which the asset is being used. Whether an impairment test is performed will depend on how significant the asset to be abandoned is to the asset group, which will require the use of professional judgment.

**Should the entity revise the useful life of some of the long-lived assets, including the leased asset?**

ASC 360-10-35-22 notes that when a long-lived asset is tested for recoverability, it also may be necessary to review depreciation estimates and method as required by ASC 250 (see ASC 250-10-45-17 through 45-20 and 250-10-50-4). Any revision to the remaining useful life of a long-lived asset resulting from that review also should be considered in developing future cash flow estimates when testing the asset (asset group) for recoverability.

Also, if an entity commits to a plan to abandon a long-lived asset before the end of its previously estimated useful life, ASC 360-10-35-47 notes that depreciation estimates should be revised to reflect the asset's use over its shortened useful life.

See also ASC 360-10-S99-2 (SAB Topic 5.CC, Impairments) for an example related to a mainframe computer to be abandoned for additional considerations, including timing of revision of estimated useful lives, and below for an SEC staff speech on this topic.

**Should the entity record additional liabilities under other standards, such as exit or disposal cost obligations (ASC 420, Exit or Disposal Cost Obligations)?**

While charges that are considered lease payments (whether fixed or variable) are excluded from the guidance in ASC 420 on exit or disposal cost obligations, if the lease contract includes nonlease components and the lessee elected to separate the lease and non-lease components, the lessee should accrue the portion of fixed payments and estimated variable payments allocated to the non-lease components on the cease-use date of an underlying asset subject to a lease. This is summarized in the following table:

|  |  |
|--|--|
| Lessee elected non-separation practical expedient.       | <ul style="list-style-type: none"> <li>▶ Payments for non-lease components or non-components (e.g. taxes, insurance) are all <u>lease</u> payments (whether fixed or variable), and therefore are outside the scope of ASC 420.</li> </ul> |
| Lessee did not elect non-separation practical expedient. | <ul style="list-style-type: none"> <li>▶ The lessee should accrue the portion of the fixed payments and estimated variable payments allocable to the nonlease component (for example, common area maintenance).</li> </ul>                 |

The SEC staff also discussed the accounting for abandonment of right-of-use assets at the 2020 AICPA Conference on Current SEC and PCAOB Developments.



## SEC STAFF GUIDANCE

### Remarks before the 2020 AICPA Conference on Current SEC and PCAOB Developments

Geoff Griffin, Professional Accounting Fellow, Office of the Chief Accountant

December 7, 2020

#### Right-of-use asset guidance

The second topic I would like to discuss today relates to the accounting for abandonment of right-of-use assets under the leases standard.

Consider a fact pattern where the registrant identified leases for abandonment, but expected there to be an extended period of time between the identification of abandonment and the actual abandonment date. The registrant noted that the leases standard requires a lessee to recognize any impairment loss for a right-of-use asset in accordance with existing guidance on impairment or disposal of long-lived assets;<sup>[9]</sup> however, upon performing an impairment assessment of the asset group, the registrant concluded there was no impairment. In this fact pattern, the registrant's identification of specific leases for abandonment did not result in a change to the asset group (i.e., the lowest level of identifiable cash flows) for which it assessed impairment.

The registrant noted that the leases standard did not provide explicit guidance to address its unique circumstances. The registrant identified a number of alternatives that it believed could be acceptable but ultimately concluded that it would be appropriate to adjust the amortization period of the right of use assets associated with the leases identified for abandonment. Given its plans to abandon these leases, and in the absence of any impairment, the registrant re-evaluated the economic life of the associated right-of-use assets and determined that the remaining right-of-use assets should be amortized ratably over the period between identification of abandonment and the actual abandonment date.

The staff did not object to the registrant's conclusion.”

[9] See ASC 842-20-35-9.

**BDO INSIGHTS – OPERATING LEASE RIGHT-OF-USE ASSET NOT IMPAIRED, BUT FOR WHICH ESTIMATED USEFUL LIFE IS SHORTENED**

If a right-of-use asset is determined to not be impaired under ASC 360, there is no basis to write down the carrying amount of the right-of-use asset. However, as previously discussed, a lessee may have to revise (shorten) the previously estimated useful life of the asset when a lessee anticipates abandoning it prior the end of the lease term. When this occurs, the link between the economic benefits to be derived from the lease and the lease payments is broken, similar to the FASB's view described below in Accounting for Operating Leases Once Impaired.

In those situations, while not explicit in ASC 842, we believe it may be appropriate for the lessee to account for the operating lease as if the right-of-use asset has been impaired. This is also consistent with the SEC staff speech reproduced above.

### 5.9.3 Accounting for Operating Leases Once Impaired

After a right-of-use asset has been impaired, it is subsequently measured at its carrying amount immediately after the impairment less any accumulated amortization, and is amortized from the impairment date to the earlier of the end of its useful life or the end of the lease term. A previously recognized impairment loss cannot be reversed.

For an operating lease, this means that the updated single lease cost following an impairment is calculated as the sum of the following:

- ▶ Amortization of the remaining balance of the right-of-use asset after the impairment, generally on a straight-line basis (unless another systematic basis is more representative of the pattern in which the lessee expects to consume the remaining economic benefits from its right to use the underlying asset),
- ▶ Accretion of the lease liability using the interest method, as before the impairment.



#### PATTERN OF LEASE COST IS NO LONGER STRAIGHT-LINE ONCE OPERATING LEASE ROU ASSET IS IMPAIRED

When an operating lease ROU asset is impaired, the FASB concluded in BC259 of ASU 2016-02 “that the link that many perceive between the economic benefits to be derived from the lease and the lease payments, and reference in support of a single, generally straight-line lease cost for operating leases, is effectively “broken” after the right-of-use asset is impaired because the lessee will no longer obtain future economic benefits from the lease equal to (or greater than) the payments it is required to make to the lessor. In other words, the lease payments no longer have any direct correlation to the economic benefits the lessee is able to derive from the lease but, instead, represent a liability reflective of a past expectation of economic benefits that could be derived from the lease.”

Therefore, while a lessee will continue to recognize a single lease cost for an operating lease following an impairment, it will no longer be recognized on a straight-line basis.

**BDO INSIGHTS – OPERATING LEASE RIGHT-OF-USE ASSET IMPAIRED AND SUBSEQUENTLY MODIFIED OR REMEASURED**

After a right-of-use asset is impaired, the lease may be subsequently modified (and that modification is not accounted for as a separate contract), or the lease may be remeasured (for example, because of a reassessment of the lease term or purchase option). As discussed in Reassessments and Modifications, certain reassessment events and modifications not accounted for as a separate contract result in accounting for the lease essentially in the same way as a new lease. Even so, we believe the lessee should continue to apply the guidance on operating leases that have been impaired. This is because the link between the economic benefits to be derived from the lease and the lease payments continues to be “broken” even after a modification or reassessment. That is, the lessee continues to no longer obtain future economic benefits from the lease equal to (or greater than) the revised lease payments. Therefore, the lessee continues to amortize the remeasured right-of-use asset on a straight-line basis.

### EXAMPLE 6.10 - IMPAIRMENT OF RIGHT-OF-USE ASSET - OPERATING LEASE

#### FACTS

- ▶ Assume the same facts as in Examples 6 and 6.2 apply, in which the lease of retail space is an operating lease. Also assume the following:
- For impairment testing purposes, the leased retail space is part of Asset Group A, which includes the operating lease right-of-use asset, leasehold improvements, inventory and operating payables.
  - At the end of Year 2 of the lease, there is a significant adverse change in the business climate and lower financial performance than initially anticipated, and Retailer Co. tests Asset Group A for recoverability.
  - The asset group is comprised of the right-of-use asset with an ending balance of \$750,556, unamortized leasehold improvements of \$100,000, and the carrying value of inventory and operating payables offset each other. The ending balance of the lease liability is \$805,114.
  - Retailer Co. elected to assess impairment by applying Approach C (explained below).
  - Based on that approach, assume that the undiscounted expected cash flows associated with Asset Group A are determined to be \$40,000 over the remaining lease term, and the fair value of Asset Group A is \$35,000.

#### ANALYSIS

- ▶ Retailer Co. applies Approach C as follows:

| APPROACH C   |  |
|--|--|
| <b>Step 1 - Determine the carrying amount of the asset group by including the operating lease liability</b>          | \$45,442 (ROU asset of \$750,556, less lease liability of \$805,114, plus unamortized leasehold improvements of \$100,000).  |
| <b>Step 1 - Determine the undiscounted expected cash flows which include the entire amount of the lease payments</b> | \$40,000.<br>The asset group is considered not recoverable as the carrying value of the asset group of \$45,442 is higher than the undiscounted cash flows of \$40,000. Retailer Co. proceeds to Step 2. |
| <b>Step 2 - Determine the impairment loss using a fair value approach such as the DCF analysis.</b>                  | \$10,442 (carrying value of \$45,442 less fair value of \$35,000).   |

- ▶ Retailer Co. records an impairment charge of \$10,442. The impairment loss is applied on a pro rata basis only to the long-lived assets in the asset group, which in this Example are the operating lease right-of-use asset and the leasehold improvements. The impairment loss does not reduce each long-lived asset's carrying value below their respective fair value and therefore Retailer Co. records a journal entry as follows:

| \$                     | \$     |                              |
|------------------------|--------|------------------------------|
| Impairment loss        | 10,442 |                              |
| Right-of-use asset     | 9,215  | = 10,442 * (750,556/850,556) |
| Leasehold improvements | 1,227  | = 10,442 * (100,000/850,556) |

- ▶ The carrying amount of the right-of-use asset after impairment is \$741,341.
- ▶ Retailer Co. determines that amortizing the right-of-use asset over the remaining lease term remains appropriate (that is, the useful life is not shortened).
- ▶ Retailer Co. recognizes a single lease cost as determined under ASC 842-20-25-7. Therefore, the single lease cost in each period following the impairment is calculated as the sum of (a) the straight-line amortization of the remaining carrying amount of the right-of-use asset over the remaining lease term of 8 years, and (b) the interest accretion of the lease liability in each of the remaining years (which is unchanged). This results in the single lease cost no longer being fixed at each of the remaining periods, as illustrated in the following table.

|         | ROU Asset<br>Opening<br>balance | Amortization | ROU Asset<br>Closing<br>balance | Interest on<br>liability | Periodic lease<br>cost |
|---------|---------------------------------|--------------|---------------------------------|--------------------------|------------------------|
|         | [A]                             | [B]          | [A] + [B]                       | [C]                      | [B] + [C]              |
| Year 3  | 741,341                         | -92,668      | 648,673                         | -48,307                  | -140,974               |
| Year 4  | 648,673                         | -92,668      | 556,006                         | -44,590                  | -137,258               |
| Year 5  | 556,006                         | -92,668      | 463,338                         | -40,320                  | -132,988               |
| Year 6  | 463,338                         | -92,668      | 370,671                         | -35,446                  | -128,114               |
| Year 7  | 370,671                         | -92,668      | 278,003                         | -29,915                  | -122,583               |
| Year 8  | 278,003                         | -92,668      | 185,335                         | -23,669                  | -116,337               |
| Year 9  | 185,335                         | -92,668      | 92,668                          | -16,647                  | -109,315               |
| Year 10 | 92,668                          | -92,668      | —                               | -8,781                   | -101,449               |

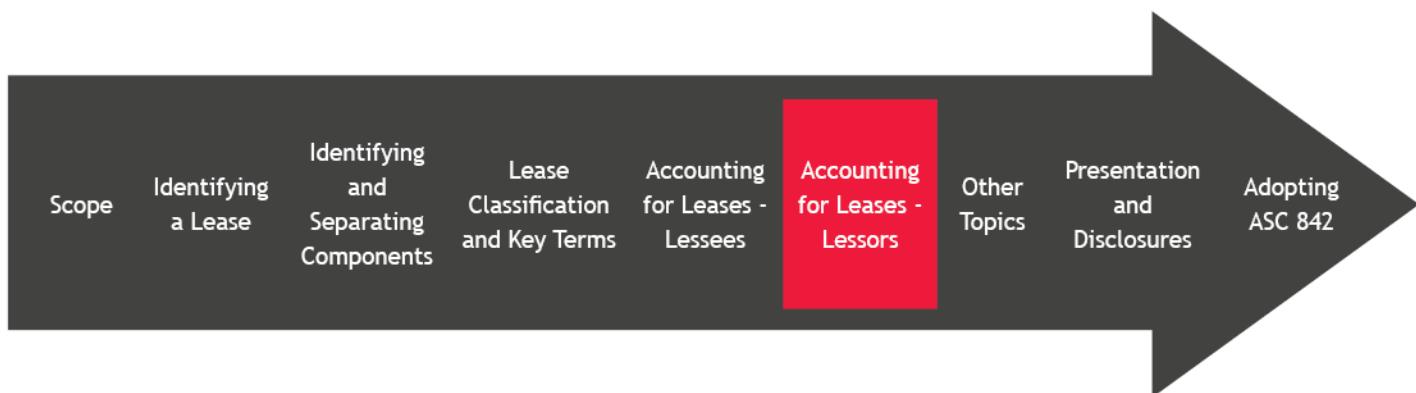
## 5.10 DERECOGNITION

ASC 842 provides specific derecognition requirements for the following events:

| ACCOUNTING  |  |
|---|--|
| <b>Lease termination before expiration of lease term</b>  | <ul style="list-style-type: none"> <li>▶ Derecognize right-of-use asset and lease liability</li> <li>▶ Recognize any difference in profit or loss</li> </ul>   |
| <b>Purchase of the underlying asset</b>   | <ul style="list-style-type: none"> <li>▶ Adjust the carrying amount of the asset for any difference between the purchase price and the carrying amount of the lease liability immediately before the purchase.</li> <li>▶ This accounting does not apply for underlying assets acquired in a business combination, which are initially measured at fair value in accordance with ASC 805-20-30-1.</li> </ul>   |
| <b>Sublease in which the original lessee is relieved of primary obligation under the original lease</b> | <ul style="list-style-type: none"> <li>▶ Derecognize right-of-use asset and lease liability</li> <li>▶ Recognize any difference in profit or loss</li> <li>▶ Any consideration paid or received upon termination that was not already included in the lease payments (for example, a termination payment) is included in the determination of profit or loss to be recognized.</li> <li>▶ If original lessee is secondarily liable, the lessee also recognizes a guarantee obligation in accordance with ASC 405-20-40-2.</li> </ul> |



# CHAPTER 6 – ACCOUNTING FOR LEASES – LESSORS



## 6.1 OVERVIEW

This chapter addresses the accounting by lessors for leases classified as sales-type leases, direct financing leases, or operating leases as discussed in Chapter 4.

The primary objective of ASC 842 was to improve accounting for leases by lessees. Accordingly, the accounting for leases by lessors remains broadly consistent with previous GAAP and varies depending on lease classification. While ASC 842 did not significantly change the accounting for lessors, the previous accounting model was not retained in its entirety. For example, some aspects of the new leases guidance were aligned between lessees and lessors.

Since leasing is fundamentally a revenue-generating activity for lessors, some of the changes in ASC 842 were also required as a result of the issuance of ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*, which superseded all other previous GAAP on revenue recognition that formed the basis for some aspects of the previous lessor accounting model, such as the accounting for sales of real estate. The changes were intended to maintain cohesion between the revenue recognition (and related cost) guidance applicable to sellers of tangible goods under ASC 606 and the guidance applicable to lessors of those same assets under ASC 842.

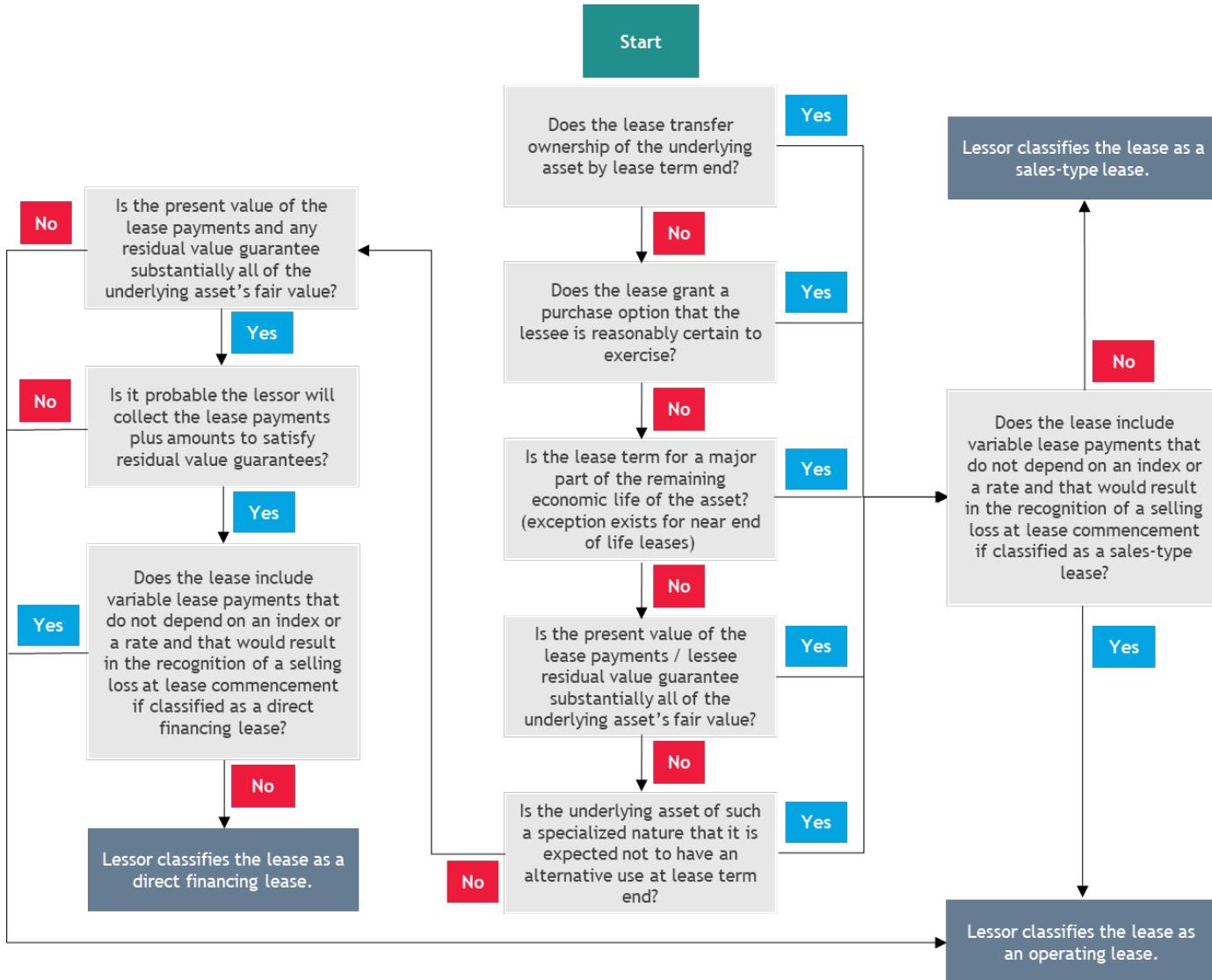
Some users of financial statements also criticized the level of information disclosed by lessors under previous GAAP and asked for additional information about a lessor's exposure to credit risk and residual-asset risk. Consequently, lessors are now required to provide enhanced disclosures on these areas, including providing the carrying amounts of the components in sales-type and direct financing leases (namely, the lease receivable, the unguaranteed residual asset, and for direct financing leases, deferred selling profit), along with information about how a lessor manages its risks associated with the residual value of underlying assets.

The accounting under ASC 842 for lessees and lessors is broadly symmetrical in the statement of comprehensive income but not in the statement of financial position. While lessees are required to record a lease liability for all leases at lease commencement (except for short-term leases if the election is made), lessors will not record a lease receivable for operating leases. Lessors will also recognize the economic benefits associated with the underlying asset and the lease in a single unit of account, namely a net investment in the lease for sales-type and direct financing leases. Lessors will continue to recognize the underlying asset for operating leases.

For discussion on a lessor's practical expedient to not separate lease and nonlease components in an operating lease, see Chapter 3, *Identifying and Separating Components*.

## 6.2 LEASE CLASSIFICATION BY LESSORS

Consistent with previous GAAP and as discussed further in Chapter 4, the lessor accounting model distinguishes between sales-type, direct financing, and operating leases as follows:



### SALES-TYPE OR DIRECT FINANCING LEASES WITH DAY-ONE LOSS

Under ASC 842, a lessor excludes from the consideration in the contract, and therefore from lease payments, most variable payments related to the use of the asset (such as the volume of electricity generated by a solar farm). Depending on the magnitude of those variable payments, this may result in the recognition of a selling loss at the commencement date (a “day-one loss”) for a sales-type or direct financing lease if the net investment in the lease recognized is less than the carrying amount of the underlying asset derecognized. Those excluded variable payments are then recognized entirely as lease income when the changes in facts and circumstances on which those variable payments are based occur. However, in July 2021 the FASB issued ASU 2021-05 to address this day-one loss issue and which is reflected in the above flowchart. See Chapter 9, *Adopting ASC 842*, for additional information.

## 6.3 SUMMARY ACCOUNTING REQUIREMENTS BASED ON LEASE CLASSIFICATION

|                  | SALES-TYPE LEASE  | DIRECT FINANCING LEASE  | OPERATING LEASE  |
|------------------|---|---|--|
| Balance Sheet    | <ul style="list-style-type: none"> <li>▶ If collectibility is probable, derecognize the underlying asset and recognize a net investment in the lease at the commencement date.</li> <li>▶ If collectibility is not probable, continue to recognize the underlying asset and record any payments received as a deposit liability.</li> </ul>   | <ul style="list-style-type: none"> <li>▶ Derecognize the underlying asset and recognize a net investment in the lease at the commencement date.</li> <li>▶ Selling profit, if any, is deferred and included in the net investment in the lease.</li> </ul>                              | <ul style="list-style-type: none"> <li>▶ Continue to recognize the underlying asset.</li> <li>▶ Initial direct costs are deferred.</li> </ul>  |
|                  | <ul style="list-style-type: none"> <li>▶ If collectibility was probable initially, subsequently increase the net investment in the lease to reflect interest income and reduce it as lease payments are received. Also assess the net investment in the lease for impairment under ASC 310 (or ASC 326).</li> <li>▶ If collectibility was not probable initially, monitor collectibility and certain other events (termination of contract or repossession of the underlying asset).</li> </ul> | <ul style="list-style-type: none"> <li>▶ Subsequently, increase the net investment in the lease to reflect interest income, and reduce it as payments are received.</li> <li>▶ Assess the net investment in the lease for impairment under ASC 310 (or ASC 326).</li> </ul>             | <ul style="list-style-type: none"> <li>▶ The underlying asset is subject to other GAAP (e.g., ASC 360 on PP&amp;E, including for impairment)</li> <li>▶ Initial direct costs are amortized over the lease term.</li> </ul>   |
| Income Statement | <ul style="list-style-type: none"> <li>▶ Recognize selling profit or loss at the commencement date of the lease.</li> <li>▶ Initial direct costs - If the fair value of the underlying asset is different than its carrying amount, expense them. Otherwise, those are deferred and included in the net investment in the lease.</li> </ul>   | <ul style="list-style-type: none"> <li>▶ Recognize selling profit over the lease term through interest income. If there is a selling loss, recognize at the commencement date.</li> <li>▶ Initial direct costs are deferred and included in the net investment in the lease.</li> </ul> | <ul style="list-style-type: none"> <li>▶ If collectibility is probable, recognize lease payments in income over the lease term, usually on a straight-line basis. Otherwise, lease income is limited generally to lease payments collected.</li> <li>▶ Expense initial direct costs on same basis as lease income over the lease term.</li> <li>▶ Recognize variable lease payments in the period in which the changes in facts and circumstances on which they are based occur.</li> <li>▶ Recognize any impairment charges of the underlying asset under ASC 360.</li> </ul> |

### 6.3.1 Fair Value Exception for Non-Manufacturers or Dealers

A lessor applies the guidance in ASC 820 on fair value measurement when determining the fair value of an underlying asset. However, for lessors that are not manufacturers or dealers (i.e., generally financial institutions and captive finance companies), the fair value of the underlying asset at lease commencement is defined as its cost, reflecting any volume or trade discounts that apply. This exception applies only if there has not been a significant lapse of time between the acquisition of the underlying asset and lease commencement. If there has been a significant lapse of time, the lessor must apply the ASC 820 definition of fair value.

This fair value exception is consistent with the fair value exception that existed under ASC 840, which the FASB added to ASC 842 with the issuance of ASU 2019-01 following feedback from lessors previously qualifying for the exception in ASC 840.

### 6.3.2 Lessor Costs to Ready the Leased Asset for Its Intended Use

A lessor may incur costs to ready the leased asset for its intended use, such as shipping, mobilization, and similar costs. Costs for such activities are not initial direct costs because those are not costs to *obtain* a lease contract. Therefore, a lessor cannot capitalize such costs by applying the guidance on initial direct costs. However, questions arose as to whether such costs should be expensed in all cases or could be capitalized by analogy to other GAAP. The SEC staff addressed this question.



#### SEC STAFF GUIDANCE

##### Remarks before the 2018 AICPA Conference on Current SEC and PCAOB Developments

Andrew W. Pidgeon, Professional Accounting Fellow, Office of the Chief Accountant

December 10, 2018

##### Certain lessee and lessor costs

In addition to transition questions, we have received application questions related to the new leases standard, including questions regarding lessee and lessor accounting for certain costs relating to a lease.

[...] The second lease cost consultation related to lessor accounting for costs incurred to fulfill its obligations under a lease. For example, a lessor may incur costs to transport a leased asset to the lessee. If the specific lessor costs are not within the scope of other GAAP, and to the extent the costs would qualify for deferral if the lease was within the scope of Topic 606,[11] in lieu of recognizing those costs in current period earnings, the staff did not object to a lessor's analogy to Subtopic 340-40 as an accounting policy election.

I encourage lessees and lessors that elect to apply either of those accounting policies to apply the policies consistently and include appropriate disclosure of those policies if material."

[11] FASB ASC Topic No. 606, Revenue from Contracts with Customers ("Topic 606").

Accordingly, unless other U.S. GAAP apply, we believe that either of the following approaches is acceptable as an accounting policy election applied to all leases, and disclosed if material:

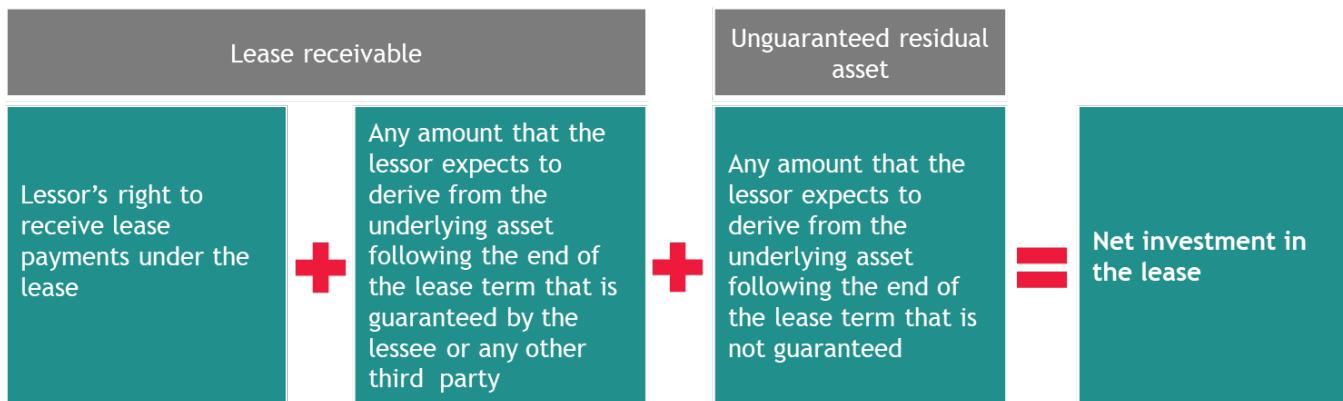
- ▶ Expense the costs as incurred, or
- ▶ Capitalize the costs by analogy to the guidance on contract fulfillment costs under ASC 340-40, *Other Assets and Deferred Costs - Contracts with Customers*, assuming the costs meet the criteria for capitalization. If capitalized, the costs are subsequently measured in accordance with ASC 340-40-35.

See also Section 6.3.1 above for lessors that are not manufacturers or dealers. For example, assuming there has been no significant lapse of time between acquisition and lease commencement, a lessor that classifies a lease as sales-type or direct-financing would capitalize the fulfillment costs in the initial measurement of the net investment in the lease.

## 6.4 SALES-TYPE LEASES - A DEEPER DIVE

### 6.4.1 Collectibility Is Probable at Commencement Date

In a sales-type lease, the lessor is considered to transfer control of the underlying asset to the lessee at the commencement date (See Chapter 4). Therefore, assuming collectibility of the lease payments, including any amount necessary to satisfy a lessee residual value guarantee is probable, a lessor recognizes a net investment in the lease and derecognizes the underlying asset at lease commencement, with any selling profit or loss arising from the lease recognized immediately. The net investment in a sales-type lease is the sum of the following, discounted using the rate implicit in the lease (See Chapter 4):



Because of the way the rate implicit in the lease is defined, the net investment in the lease recognized typically will equal the fair value of the underlying asset plus any deferred initial direct costs (less prepaid lease payments, if any).

At the commencement date, the selling profit or selling loss equals the following:



Initial direct costs are expensed if the fair value of the underlying asset at the commencement date is different than its carrying amount. Otherwise, initial direct costs are deferred and included in the measurement of the net investment in the lease and are reflected in the calculation of the rate implicit in the lease.

If a lessor concludes that collectibility is probable at commencement, it does not reassess that conclusion. Subsequent changes in the credit risk of the lessee are accounted for in accordance with the impairment (or credit loss) guidance applicable to the net investment in the lease. See Impairment Section in this Chapter for additional discussion.

After the commencement date, a lessor measures the net investment in the lease by:

- ▶ Increasing the carrying amount to reflect interest income on the net investment in the lease, using the rate implicit in the lease.
- ▶ Reducing the carrying amount to reflect the lease payments collected during the period.

Also, the net investment in the lease is not remeasured after the commencement date except in a lease modification that is not accounted for as a separate contract. See Modification Section in this Chapter for additional discussion.

A lessor also recognizes the following in the statement of operations:

- ▶ Interest income on the net investment in the lease using the rate implicit in the lease.
- ▶ Variable lease payments that are not included in the net investment in the lease as income in the period when the changes in facts and circumstances on which the variable lease payments are based occur.
- ▶ Impairment (or credit losses) on the net investment in the lease.

#### **6.4.2 Collectibility Is Not Probable at Commencement Date**

If collectibility of the lease payments, plus any amount necessary to satisfy a lessee residual value guarantee is not probable at lease commencement, a lessor does not derecognize the underlying asset. Instead, it recognizes any lease payments received, including variable lease payments, as a deposit liability. The lessor then continues to monitor collectibility for any changes in assessment. The deposit liability recorded for payments received is derecognized at the earlier of the following events:

|  |   |
|--|---|
|  | Collectibility of the lease payments and any amounts required to satisfy a lessee residual value guarantee becomes probable.  |
|  | The contract has been terminated, and the lease payments received from the lessee are nonrefundable.  |
|  | The lessor has repossessed the underlying asset, has no further obligation under the contract to the lessee, and the lease payments received from the lessee are nonrefundable. |

Also, the accounting for derecognizing the deposit liability depends on which event above occurred.

- On the date that collectibility of the lease payments plus any amount necessary to satisfy a lessee residual value guarantee is assessed as probable, the lessor:
  - ▶ Derecognizes the carrying amount of the underlying asset,
  - ▶ Derecognizes the carrying amount of any deposit liability recognized,
  - ▶ Recognizes a net investment in the lease based on the remaining lease payments and remaining lease term, using the rate implicit in the lease determined at the commencement date, and
  - ▶ Recognizes selling profit or selling loss calculated as:
    - The lease receivable; plus
    - The carrying amount of the deposit liability; minus
    - The carrying amount of the underlying asset, net of the unguaranteed residual asset.

- At the date the contract is terminated, or the asset is repossessed with no further obligation to the lessee, and assuming in both cases that the lease payments received are nonrefundable, the lessor derecognizes the carrying amount of any deposit liability with the corresponding amount recognized as lease income.

The above treatment for sales-type leases when collectibility is not probable is consistent with the guidance in ASC 606 related to contracts with customers for which collectibility of the consideration is not probable. However, it represents a change from prior guidance, which resulted in operating lease classification when collectibility was not probable.

In assessing collectibility, a lessor should consider all facts and circumstances regarding the lessee's ability and intent to pay, including:

- ▶ the lessee's credit quality
- ▶ other income or assets with which the lessee could make the lease payments if the business in which the asset is used is not successful
- ▶ the economic climate of the business in which the asset will be used (level of competition and risk, lessee experience in the industry, etc.)
- ▶ the lessor's history of collections and repossession with similar lessees
- ▶ the lessor's past practice of providing any concessions or waivers to its lessees

The topic of collectibility assessment by a lessor for sales-type leases was discussed by the SEC staff.



## SEC STAFF GUIDANCE

### Remarks before the 2018 AICPA Conference on Current SEC and PCAOB Developments

Erin Bennet, Professional Accounting Fellow, Office of the Chief Accountant

December 9, 2019

#### ASC 842 and Collectability

We continue to be engaged in monitoring implementation of the new lease accounting standard. I would like to share observations from a recent consultation about assessing collectibility for lessors. Under ASC 842, lessors are required to evaluate whether collectibility of the lease payments, including any amount necessary to satisfy a residual value guarantee, is probable at lease commencement date. In a sales-type lease, if collectibility is not probable, the lessor should not derecognize the asset and should defer recognition of any income or loss. The lessor would instead recognize lease payments received as a deposit liability until either: (a) collectibility becomes probable or (b) the contract has been terminated or the lessor has taken back the asset, and the lease payments are nonrefundable. *[Footnote omitted]*

OCA staff recently considered a fact pattern where the registrant enters into sales-type leases of equipment. The lessee is required to make a down payment and also make periodic lease payments, generally over a four-year contractual period. The registrant has historically experienced a high rate of payment delinquencies, leading to defaults that result in termination of the contract and, in most cases, repossession of the equipment. Based on historical experience, the registrant collects an average of 60% of the contractual lease payments. The registrant continues to expect a high rate of defaults and structures its leases to compensate for the high credit risk of its customers through a high rate implicit in the lease, a residual value guarantee, and the intent and ability to repossess the equipment if the customer defaults.

The registrant concluded collectibility of the lease payments was probable at lease inception. The registrant asserted that at the lease commencement date, the customer had the intent and ability to pay as evidenced by a credit evaluation and a substantive down payment, among other factors. *[Footnote omitted]* Further, the registrant asserted that the historical lessee defaults were generally due to a change in the lessee's circumstances subsequent to the lease inception.

The staff objected to the registrant's view and concluded that there was not a sufficient basis to assert that collectibility of the lease payments was probable at the lease commencement date. In reaching this conclusion, the staff considered all factors including the registrant's assessment of the lessee's credit quality and the registrant's history of collections with similar lessees.

### 6.4.3 Accounting at the End of Lease Term

At the end of the lease term, a lessor reclassifies the net investment in the lease to the appropriate category of asset (for example, property, plant, and equipment) in accordance with other GAAP, measured at the carrying amount of the net investment in the lease. The lessor then accounts for the underlying asset in accordance with other Topics, such as ASC 360.

### 6.4.4 Accounting for Lease Termination

If a sales-type lease is terminated before the end of the lease term, a lessor:

- ▶ Tests the net investment in the lease for impairment or credit losses under ASC 310 or ASC 326-20, respectively,
- ▶ Reclassifies the net investment in the lease to the appropriate category of asset in accordance with other GAAP, measured as the sum of the carrying amounts of the lease receivable (less any amounts still expected to be received by the lessor) and the residual asset, and
- ▶ Accounts for the underlying asset that was the subject of the lease in accordance with other GAAP, such as ASC 360.

Examples 1A through 1C below illustrate the initial and subsequent measurement of a sales-type lease, under different scenarios.

Please note that for the illustrations throughout this Chapter, the tables presented in each Example are consistent with how they would be displayed in a spreadsheet, with amounts shown with no decimals, and no rounding function used.

#### EXAMPLE 1A - SALES-TYPE LEASE WITH LESSEE RESIDUAL VALUE GUARANTEE - COLLECTIBILITY IS PROBABLE

##### FACTS

- ▶ J.R.E Inc. ("J.R.E") enters into a 6-year lease of non-specialized equipment with Lessee.
- ▶ Lease payments are \$25,000 per year, due at the end of each year. Lessee provides a residual value guarantee of \$35,000.
- ▶ At lease commencement, the equipment has a fair value of \$170,000 and a carrying value of \$150,000.
- ▶ The equipment has a remaining economic life of 10 years, and J.R.E expects the residual value of the equipment at the end of the 6-year lease term to be \$55,000.
- ▶ The lease does not transfer ownership of the equipment to Lessee nor grant it a purchase option.
- ▶ J.R.E incurs \$2,000 of initial direct costs.
- ▶ There are no nonlease components in the agreement.
- ▶ J.R.E concludes at the commencement date that it is probable it will collect the lease payments and the amount necessary to satisfy the residual value guarantee provided by Lessee.

## ANALYSIS

### Accounting on Day 1 (commencement date)

- In order to determine whether the lease is a sales-type lease, J.R.E. calculates the rate implicit in the lease as shown below. Since the fair value of the underlying asset is different than its carrying value, no initial direct costs are deferred and they are not reflected in the calculation. Also note that there are no investment tax credits. Accordingly, the rate implicit in the lease in this example is the rate that causes the aggregate present value of the lease payments and of J.R.E's expected residual value of the equipment at the end of the lease term to equal the fair value of the underlying asset at commencement.

| <b>PMT</b>                        |                |  |
|-----------------------------------|----------------|--|
| <b>Year 1</b>                     | (170,000)      | Beginning of year (commencement date)                    |
| <b>Year 1</b>                     | 25,000         | End of year payment                                      |
| <b>Year 2</b>                     | 25,000         |  |
| <b>Year 3</b>                     | 25,000         |  |
| <b>Year 4</b>                     | 25,000         |  |
| <b>Year 5</b>                     | 25,000         |  |
| <b>Year 6</b>                     | 80,000         | (25,000 lease payment + 55,000 estimated residual value) |
| <b>Undiscounted PMTs</b>          | <b>205,000</b> |  |
| <b>Rate implicit in the lease</b> | <b>4.68%</b>   |  |

- J.R.E calculates the present value of the lease payments and of the lessee residual value guarantee at the commencement date as follows, using the rate implicit in the lease determined above:

| <b>PMT</b>               |                |  |
|--------------------------|----------------|--|
| <b>Year 1</b>            | 25,000         |  |
| <b>Year 2</b>            | 25,000         |  |
| <b>Year 3</b>            | 25,000         |  |
| <b>Year 4</b>            | 25,000         |  |
| <b>Year 5</b>            | 25,000         |  |
| <b>Year 6</b>            | 60,000         | (25,000 lease payment + 35,000 lessee guaranteed residual value) |
| <b>Undiscounted PMTs</b> | <b>185,000</b> |  |
| <b>PV (4.68%) =</b>      | <b>154,800</b> |  |

- J.R.E classifies the lease as a sales-type lease because (1) the present value of the lease payments and lessee residual value guarantee amounts to substantially all of the fair value of the equipment at the commencement date ( $154,800/170,000 = 91\%$ ), and (2) ASC 842-10-25-3A on variable lease payments not based on an index or a rate does not apply.
- The net investment in the lease is initially measured at \$170,000 and represents the sum of the following:
- Lease receivable of \$154,800 (see calculation above), and
  - Unguaranteed residual asset of \$15,200 (present value of \$20,000 expected unguaranteed residual value, discounted at 4.68%).



The net investment in the lease equals the fair value of the underlying asset because there are no deferred initial direct costs nor prepaid lease payments.

- At the commencement date, J.R.E calculates the selling profit/loss as follows:

|  |               |
|--|---------------|
| Lease receivable*, minus   | 154,800       |
| Carrying value of the equipment, net of unguaranteed residual value**, minus | 134,800       |
| Deferred initial direct costs***   | —             |
| <b>Selling profit</b>  | <b>20,000</b> |

\* J.R.E uses the lease receivable as it is lower than the fair value of the underlying asset (\$170,000)

\*\* The unguaranteed residual value used for this calculation equals the PV of the difference between the amount the lessor expects to receive at the end of the lease term (\$55,000) and the lessee residual value guarantee (\$35,000).

\*\*\* The initial direct costs are not eligible for deferral because the fair value of the underlying asset is different than its carrying amount at the commencement date. Accordingly, these costs are expensed at the commencement date.

- At the commencement date, J.R.E records the following journal entry:

|                                 | \$      | \$      |
|---------------------------------|---------|---------|
| Dr. Net investment in the lease | 170,000 |         |
| Dr. Operating expenses*         | 2,000   |         |
| Cr. Cash*                       |         | 2,000   |
| Cr. Equipment - carrying value  |         | 150,000 |
| Cr. Selling profit              |         | 20,000  |

\* Assumes lease inception and lease commencement are at the same date.

*To derecognize the underlying asset at its carrying value, and recognize the net investment in the lease and selling profit.*

#### Subsequent measurement (assuming no modifications)

- J.R.E increases the carrying amount of the net investment in the lease for interest income using the rate implicit in the lease of 4.68% and reduces it to reflect the lease payments collected. For example, J.R.E records the following journal entry at the end of Year 1:

|                                 | \$     | \$     |
|---------------------------------|--------|--------|
| Dr. Cash                        | 25,000 |        |
| Cr. Net investment in the lease |        | 17,044 |
| Cr. Interest income*            |        | 7,956  |

\* Net investment in the lease of \$170,000 at 4.68%

- In accordance with ASC 842-30-30-1, and for disclosure purposes, J.R.E calculates the components of the net investment in the lease, which include the lease receivable and the unguaranteed residual asset.

- The following summarizes the accounting for the lease receivable throughout the lease term:

|               | Beg.<br>Balance<br>[A] | Interest<br>[B] = [A] x 4.68% | Payment<br>[C] | End. Balance<br>[D] = [A] + [B] + [C] |
|---------------|------------------------|-------------------------------|----------------|---------------------------------------|
| <b>Year 1</b> | 154,800                | 7,245                         | (25,000)       | 137,045                               |
| <b>Year 2</b> | 137,045                | 6,414                         | (25,000)       | 118,459                               |
| <b>Year 3</b> | 118,459                | 5,544                         | (25,000)       | 99,003                                |
| <b>Year 4</b> | 99,003                 | 4,634                         | (25,000)       | 78,637                                |
| <b>Year 5</b> | 78,637                 | 3,680                         | (25,000)       | 57,317                                |
| <b>Year 6</b> | 57,317                 | 2,683                         | (25,000)       | 35,000                                |

- The following summarizes the accounting for the unguaranteed residual asset throughout the lease term, along with the ending balance of each component and of the net investment in the lease:

|               | Unguaranteed<br>Residual<br>Asset Beg.<br>Balance<br>[A] | Interest<br>[B] = [A] x 4.68% | Unguaranteed<br>Residual Asset<br>End. Balance<br>[C] = [A] + [B] | Lease<br>Receivable<br>End. Balance<br>[D] - see above | Net Investment<br>in the Lease<br>End. Balance<br>[E] = [C] + [D] |
|---------------|--|-------------------------------|---|--|---|
| <b>Year 1</b> | 15,200   | 711                           | 15,911  | 137,045  | 152,956   |
| <b>Year 2</b> | 15,911   | 745                           | 16,656  | 118,459  | 135,115   |
| <b>Year 3</b> | 16,656   | 780                           | 17,436  | 99,003   | 116,439   |
| <b>Year 4</b> | 17,436   | 816                           | 18,252  | 78,637   | 96,889  |
| <b>Year 5</b> | 18,252   | 854                           | 19,106  | 57,317   | 76,423  |
| <b>Year 6</b> | 19,106   | 894                           | 20,000  | 35,000   | 55,000  |



At the end of the lease term, the net investment in the lease equals the estimated residual value of the asset of \$55,000, the lease receivable equals the Lessee residual value guarantee of \$35,000 and the unguaranteed residual asset is the difference between \$55,000 and \$35,000.

- The following summarizes interest income recognized in profit or loss throughout the lease term:

|               |        |
|---------------|--------|
| <b>Year 1</b> | 7,956  |
| <b>Year 2</b> | 7,159  |
| <b>Year 3</b> | 6,324  |
| <b>Year 4</b> | 5,450  |
| <b>Year 5</b> | 4,535  |
| <b>Year 6</b> | 3,577  |
| <b>Total</b>  | 35,000 |



Total interest income recognized is \$35,000, which represents the difference between (1) the undiscounted lease payments plus the expected residual value of the asset at the end of the lease term of \$205,000, and (2) the fair value of the underlying asset at the commencement date of \$170,000.

- At the end of Year 6, J.R.E reclassifies the net investment in the lease of \$55,000 to property, plant and equipment and then accounts for it under ASC 360.

**EXAMPLE 1B - SALES-TYPE LEASE WITH NO RESIDUAL VALUE GUARANTEE - COLLECTIBILITY IS PROBABLE****FACTS**

- ▶ Heisenberg Co. enters into a 10-year lease with Lessee for a piece of non-specialized equipment.
- ▶ Lease payments are \$50,000 per year and due at the beginning of each year.
- ▶ The lease does not transfer ownership of the equipment to Lessee nor grant it a purchase option.
- ▶ At lease commencement, the equipment has a fair value of \$425,000 and a carrying value of \$395,400.
- ▶ The equipment has a remaining economic life of 12 years, and Heisenberg Co. expects the residual value of the equipment at the end of the lease term to be \$20,000.
- ▶ Heisenberg Co. incurs \$5,000 of initial direct costs.
- ▶ No residual value guarantees are provided by Lessee or any other third parties unrelated to Heisenberg Co.
- ▶ There are no nonlease components in the agreement.
- ▶ Heisenberg Co. concludes at the commencement date that it is probable it will collect the lease payments.
- ▶ Heisenberg Co. uses the lease of the equipment as an alternative means of realizing value from goods it otherwise sells in the ordinary course of business. See Chapter 8 for further information on presentation of selling profit or loss.

**ANALYSIS**Accounting on Day 1 (commencement date)

- ▶ Because the lease term is for a major part (in this case 83%) of the remaining economic life of the equipment, Heisenberg classifies the lease as a sales-type lease (note that in this example the lease payments also represent substantially all of the fair value of the equipment). ASC 842-10-25-3A on variable lease payments not based on an index or a rate does not apply.
- ▶ Heisenberg Co. calculates the rate implicit in the lease as shown below. Since the fair value of the underlying asset is different than its carrying value, no initial direct costs are deferred and they are not reflected in the calculation. Also note that there are no investment tax credits.

| PMT                               |           |   |
|-----------------------------------|-----------|---|
| Year 1                            | (375,000) | (425,000 fair value - 50,000 first lease payment) |
| Year 2                            | 50,000    |   |
| Year 3                            | 50,000    |   |
| Year 4                            | 50,000    |   |
| Year 5                            | 50,000    |   |
| Year 6                            | 50,000    |   |
| Year 7                            | 50,000    |   |
| Year 8                            | 50,000    |   |
| Year 9                            | 50,000    |   |
| Year 10                           | 50,000    | Beginning of year - lease payment                 |
| Year 10                           | 20,000    | End of year - estimated residual value            |
| <b>Rate implicit in the lease</b> |           | <b>4.58%</b>                                      |

- ▶ Heisenberg Co. calculates the present value of lease payments during Years 2-10 at the commencement date discounted at 4.58% plus the lease payment received at lease commencement, which amounts to \$412,214 (or 97% of the fair value of the equipment).
- ▶ Heisenberg Co. recognizes a net investment in the lease of \$375,000 initially measured as the sum of the following:
  - Lease receivable of \$362,214 which is the present value of the remaining unpaid lease payments (or \$412,214 discussed above minus first payment of \$50,000 received). Note that there are no residual value guarantees provided by either the lessee or a third-party.
  - Unguaranteed residual asset of \$12,786 (present value of \$20,000 expected unguaranteed residual value, discounted at 4.58%).



The net investment in the lease equals the fair value of the underlying asset of \$425,000 less \$50,000 prepaid lease payment. There are no deferred initial direct costs.

- ▶ At the commencement date, Heisenberg Co. records the following entries:

|                                     | \$       | \$        |
|-------------------------------------|----------|-----------|
| Dr. Cash (lease payment for Year 1) | 50,000   |           |
| Dr. Cost of goods sold              | 382,614* |           |
| Dr. Net investment in the lease     | 375,000  |           |
| Cr. Equipment - carrying value      |          | 395,400   |
| Cr. Sales-type lease - revenue      |          | 412,214** |

*To derecognize the underlying asset at its carrying value, and recognize the net investment in the lease and selling profit.*

\* In accordance with ASC 842-30-45-4a, cost of goods sold is the carrying amount of the equipment (\$395,400) minus the unguaranteed residual asset (\$12,786).

\*\*In accordance with ASC 842-30-45-4a, revenue is recognized at the lesser of (1) the fair value of the underlying asset (\$425,000), and (2) the sum of the lease receivable and any lease payments prepaid by the lessee (\$412,214).

- ▶ Heisenberg Co. also expenses the initial direct costs as follows:

|                         | \$    | \$    |
|-------------------------|-------|-------|
| Dr. Operating expenses* | 5,000 |       |
| Cr. Cash*               |       | 5,000 |

\* Assumes lease inception and lease commencement are at the same date.

*To recognize the initial direct costs as an expense.*

#### Subsequent measurement (assuming no modifications)

- ▶ Heisenberg Co. increases the carrying amount of the net investment in the lease for interest income using the rate implicit in the lease of 4.58% and reduces it to reflect the lease payments collected. For example, Heisenberg Co. records journal entry #1 at the end of Year 1 to recognize interest accrued and journal entry #2 at the beginning of Year 2 to reflect the second lease payment:

|                                 | \$     | \$     |
|---------------------------------|--------|--------|
| Dr. Net investment in the lease | 17,157 |        |
| Cr. Interest income*            |        | 17,157 |

\* Net investment in the lease of \$375,000 multiplied by the rate implicit in the lease of 4.58%

*To recognize interest income on net investment in the lease - Year 1*

|                                 | \$     | \$     |
|---------------------------------|--------|--------|
| Dr. Cash                        | 50,000 |        |
| Cr. Net investment in the lease |        | 50,000 |

*To recognize cash payment received beginning of Year 2*

- ▶ In accordance with ASC 842-30-30-1, and for disclosure purposes, Heisenberg Co. calculates the components of the net investment in the lease, which include the lease receivable and the unguaranteed residual asset.
- ▶ The following summarizes the accounting for the lease receivable throughout the lease term:

|                | <b>Beg.<br/>Balance</b> | <b>PMT</b> | <b>Interest</b>       | <b>End.<br/>Balance</b> |
|----------------|-------------------------|------------|-----------------------|-------------------------|
|                | [A]                     | [B]        | [C] = [A + B] x 4.58% | [D] = [A] + [B] + [C]   |
| <b>Year 1</b>  | 362,214                 | -          | 16,572                | 378,785                 |
| <b>Year 2</b>  | 378,785                 | (50,000)   | 15,042                | 343,827                 |
| <b>Year 3</b>  | 343,827                 | (50,000)   | 13,443                | 307,270                 |
| <b>Year 4</b>  | 307,270                 | (50,000)   | 11,770                | 269,040                 |
| <b>Year 5</b>  | 269,040                 | (50,000)   | 10,021                | 229,062                 |
| <b>Year 6</b>  | 229,062                 | (50,000)   | 8,192                 | 187,254                 |
| <b>Year 7</b>  | 187,254                 | (50,000)   | 6,279                 | 143,533                 |
| <b>Year 8</b>  | 143,533                 | (50,000)   | 4,279                 | 97,813                  |
| <b>Year 9</b>  | 97,813                  | (50,000)   | 2,187                 | 50,000                  |
| <b>Year 10</b> | 50,000                  | (50,000)   | —                     | —                       |

- ▶ The following summarizes the accounting for the unguaranteed residual asset throughout the lease term, along with the ending balance of each component and of the net investment in the lease:

|                | <b>Unguaranteed<br/>Residual<br/>Asset Beg.<br/>Balance</b> | <b>Interest<br/>Accretion</b> | <b>Unguaranteed<br/>Residual<br/>Asset End.<br/>Balance</b> | <b>Lease<br/>Receivable<br/>End. Balance</b> | <b>Net Investment<br/>in the Lease<br/>End. Balance</b> |
|----------------|---|-------------------------------|---|--|---|
|                | [A]   | [B] = [A] x 4.58%             | [C] = [A] + [B]   | [D] See above                                | [E] = [C] + [D]   |
| <b>Year 1</b>  | 12,786  | 585                           | 13,371  | 378,785                                      | 392,157   |
| <b>Year 2</b>  | 13,371  | 612                           | 13,983  | 343,827                                      | 357,810   |
| <b>Year 3</b>  | 13,983  | 640                           | 14,623  | 307,270                                      | 321,893   |
| <b>Year 4</b>  | 14,623  | 669                           | 15,292  | 269,040                                      | 284,332   |
| <b>Year 5</b>  | 15,292  | 700                           | 15,991  | 229,062                                      | 245,053   |
| <b>Year 6</b>  | 15,991  | 732                           | 16,723  | 187,254                                      | 203,977   |
| <b>Year 7</b>  | 16,723  | 765                           | 17,488  | 143,533                                      | 161,022   |
| <b>Year 8</b>  | 17,488  | 800                           | 18,288  | 97,813                                       | 116,101   |
| <b>Year 9</b>  | 18,288  | 837                           | 19,125  | 50,000                                       | 69,125  |
| <b>Year 10</b> | 19,125  | 875                           | 20,000  | —  | 20,000  |



At the end of the lease term, the net investment in the lease equals the estimated residual value of the asset of \$20,000.

- The following summarizes interest income recognized in profit or loss throughout the lease term:

|                |        |
|----------------|--------|
| <b>Year 1</b>  | 17,157 |
| <b>Year 2</b>  | 15,654 |
| <b>Year 3</b>  | 14,083 |
| <b>Year 4</b>  | 12,439 |
| <b>Year 5</b>  | 10,721 |
| <b>Year 6</b>  | 8,924  |
| <b>Year 7</b>  | 7,045  |
| <b>Year 8</b>  | 5,079  |
| <b>Year 9</b>  | 3,024  |
| <b>Year 10</b> | 875    |
| <b>Total</b>   | 95,000 |



Total interest recognized is \$95,000 and represents the difference between (1) the undiscounted lease payments plus the expected residual value of the asset at the end of the lease term of \$520,000, and (2) the fair value of the underlying asset at the commencement date of \$425,000.

- At the end of Year 10, Heisenberg Co. reclassifies the net investment in the lease of \$20,000 to the appropriate category of asset in accordance with other GAAP.

#### EXAMPLE 1C - SALES-TYPE LEASE WITH LESSEE RESIDUAL VALUE GUARANTEE - COLLECTIBILITY IS NOT PROBABLE

##### FACTS

- Assume the same facts as in Example 1A above, except that at the commencement date, J.R.E Inc. concludes that collectibility of the lease payments plus the amount necessary to satisfy Lessee's residual value guarantee is not probable. In reaching this conclusion, J.R.E considers both Lessee's ability and intent to pay the required payments. Specifically, Lessee has limited credit history and no significant other income or assets with which to make the payments if its operations were unsuccessful.
- Also assume that at the end of Year 3, collectibility of the lease payments and the amount necessary to satisfy Lessee's residual value guarantee become probable, and that the contract has not been terminated and the underlying asset has not been repossessed.

##### ANALYSIS

###### Accounting while collectibility is not probable

- At the commencement date, because collectibility is not probable, J.R.E continues to recognize the equipment. That is, it does not recognize a net investment in the lease nor any selling profit or selling loss.
- Consistent with Example 1A, the initial direct costs are expensed at the commencement date.
- J.R.E continues to reassess collectibility to determine whether the lease payments and the amount necessary to satisfy Lessee's residual value guarantee are probable of collection. For years 1 and 2, collectibility is still not probable. Therefore, J.R.E accounts for the \$25,000 Year 1 and Year 2 lease payments received as a deposit liability.
- Also, since the underlying asset is not derecognized, J.R.E recognizes depreciation expense on the equipment. In this example, assume annual depreciation is \$15,800. The following journal entries are recorded in each year:

|                          |        |        |
|--------------------------|--------|--------|
|                          | \$     | \$     |
| Dr. Cash                 | 25,000 |        |
| Cr. Deposit liability    |        | 25,000 |
|                          | \$     | \$     |
| Dr. Depreciation expense | 15,800 |        |
| Cr. Equipment            |        | 15,800 |

#### Accounting once collectibility becomes probable

- ▶ At the end of Year 3, Lessee makes the \$25,000 payment due under the lease, which J.R.E. records as a deposit liability. The updated balance of the deposit liability is therefore \$75,000.
- ▶ Depreciation expense of \$15,800 is recorded on the equipment. Therefore, the updated carrying amount of the equipment is \$102,600 [\$150,000 carrying value at the commencement date - (\$15,800 x3)].
- ▶ At the end of Year 3, J.R.E concludes that collectibility of the lease payments plus the amount necessary to satisfy Lessee's residual value guarantee is now probable based on Lessee's payment history under the lease (three lease payments made on time) and the fact that the business in which the leased asset is used has proven to be successful and has significantly improved since the commencement date.
- ▶ J.R.E does not reassess the classification of the lease. That is, it remains a sales-type lease.
- ▶ Once collectibility is probable at the end of Year 3, J.R.E:
  - Derecognizes the carrying amount of the equipment (i.e., \$102,600)
  - Derecognizes the carrying amount of the deposit liability (i.e., \$75,000)
  - Recognizes a net investment in the lease based on the remaining lease payments and remaining lease term, using the rate implicit in the lease determined at the commencement date (i.e., 4.68%).
  - Recognizes a selling profit or loss (see below for calculation).
- ▶ The net investment in the lease is calculated as follows:

| PMT                      |                |  |
|--------------------------|----------------|--|
| Year 4                   | 25,000         |  |
| Year 5                   | 25,000         |  |
| Year 6                   | 80,000         | (25,000 lease payment + 55,000 estimated residual value)     |
| <b>Undiscounted PMTs</b> | <b>130,000</b> |  |
| <b>PV (4.68%) =</b>      | <b>116,439</b> | (rate implicit in the lease determined at commencement date) |

- ▶ The net investment in the lease of \$116,439 consists of the following:
  - Lease receivable of \$99,003 (present value of 3 lease payments of \$25,000 and the amount of Lessee's residual value guarantee of \$35,000 at the end of the lease term), and
  - Unguaranteed residual asset of \$17,436 [(\$55,000 estimated residual value - \$35,000 Lessee guaranteed amount) \* (1.0468)^{-3}].



The above balances are same as the ending balances in Example 1A at the end of Year 3 since none of the accounting assumptions (e.g., estimated residual value) have been updated.

- J.R.E calculates the selling profit/loss as follows:

|  |               |
|--|---------------|
| Lease receivable (\$99,003) plus deposit liability balance (\$75,000), minus           | 174,003       |
| Carrying value of equipment (\$102,600), net of unguaranteed residual asset (\$17,436) | <u>85,164</u> |
| <b>Selling profit</b>  | <b>88,839</b> |

- J.R.E records the following journal entry:

|                                       | \$      | \$      |
|---------------------------------------|---------|---------|
| Dr. Net investment in the lease       | 116,439 |         |
| Dr. Deposit liability                 | 75,000  |         |
| Cr. Equipment - carrying value        |         | 102,600 |
| Cr. Sales-type lease - selling profit |         | 88,839  |

- J.R.E then accounts for the remaining three years of the lease as any other sales-type lease. The following summarizes the accounting for the net investment in the lease for the remaining three years:

|               | <b>Beg.</b>    |                   |                | <b>End.</b>           |
|---------------|----------------|-------------------|----------------|-----------------------|
|               | <b>Balance</b> | <b>Interest</b>   | <b>Payment</b> | <b>Balance</b>        |
|               | [A]            | [B] = [A] × 4.68% | [C]            | [D] = [A] + [B] + [C] |
| <b>Year 4</b> | 116,439        | 5,450             | (25,000)       | 96,889                |
| <b>Year 5</b> | 96,889         | 4,535             | (25,000)       | 76,423                |
| <b>Year 6</b> | 76,423         | 3,577             | (25,000)       | 55,000                |

- At the end of the lease (Year 6), J.R.E reclassifies the net investment in the lease, then equal to the estimated residual value of the asset of \$55,000 to property, plant and equipment and accounts for it under ASC 360.

## 6.5 DIRECT FINANCING LEASES - A DEEPER DIVE

### 6.5.1 Recognition and Initial Measurement

A lessor classifies a lease as a direct financing lease if none of the criteria for sales-type lease classification are met and if both of the following criteria apply:

- ▶ The present value of the sum of the lease payments and any residual value guaranteed by the lessee and/or any other third party unrelated to the lessor equals or exceeds substantially all of the fair value of the underlying asset.
- ▶ It is probable that the lessor will collect the lease payments plus any amount necessary to satisfy a residual value guarantee.

Even though the above two conditions may be met, a lessor will classify the lease as operating if the lease includes variable lease payments that do not depend on an index or a rate and that would result in the recognition of a selling loss at lease commencement if the lease were classified as a direct financing lease.

Also, if a lessor classifies a lease as an operating lease because collectibility is not probable, subsequent changes in collectibility do not change lease classification (i.e., the lease continues to be classified as operating). However, collectibility will affect the amount of lease income recognized in profit or loss. See Operating Leases Section in this Chapter for additional discussion.

For a lease classified as a direct financing lease, the lessor converts its risk in the underlying asset (asset risk) into credit risk. Therefore, a lessor recognizes a net investment in the lease at the commencement date and derecognizes the underlying asset. The net investment in a direct financing lease is calculated the same way as for a sales-type lease, except that:

- ▶ Any selling profit arising from the lease (see calculation in the Sales-Type Leases section above) is deferred and recognized as part of the subsequent measurement of the net investment in the lease.
- ▶ Initial direct costs incurred are deferred and included in the measurement of the net investment in the lease, regardless of whether the fair value of the underlying asset at the commencement date equals its carrying amount or not. The rate implicit in the lease is defined in such a way that initial direct costs deferred are included automatically in the net investment in the lease.

The following summarizes the initial measurement of the net investment in a direct financing lease:

| Lease receivable   | Unguaranteed residual asset  | Deferred selling profit   | Net investment in the lease      |
|--|--|---|----------------------------------|
| Lessor's right to receive lease payments under the lease | Any amount that the lessor expects to derive from the underlying asset following the end of the lease term that is guaranteed by the lessee or any other third party | Any amount that the lessor expects to derive from the underlying asset following the end of the lease term that is not guaranteed | The amount of any selling profit |

Because of the way the rate implicit in the lease is defined and because selling profit is deferred in a direct financing lease, the net investment in a direct financing lease recognized typically will equal the carrying value of the underlying asset plus any initial direct costs (less prepaid lease payments, if any).

Like sales-type leases, a lessor does not reassess whether collectibility is probable for leases that are classified as a direct financing lease after the commencement date. Subsequent changes in the credit risk of the lessee are accounted for in accordance with the impairment (or credit loss) guidance applicable to the net investment in the lease. See Impairment Section in this Chapter for additional discussion.

### 6.5.2 SUBSEQUENT MEASUREMENT

After the commencement date, a lessor measures the net investment in the lease by:

- ▶ Increasing the carrying amount to reflect interest income on the net investment in the lease using the rate implicit in the lease (but unlike a sales-type lease, the rate implicit in the lease is determined using the carrying amount of the underlying asset rather than its fair value since selling profit is deferred and recognized over the lease term).
- ▶ Reducing the carrying amount to reflect the lease payments collected during the period.



#### INTEREST INCOME ACCRETION FOR A DIRECT FINANCING LEASE REQUIRES DIFFERENT RATES

As discussed above, total periodic interest income recognized on a direct financing lease is determined based on the carrying amount of the net investment in the lease multiplied by the rate implicit in the lease (which is determined using the carrying amount of the underlying asset). However, a lessor uses the rate implicit in the lease (using the fair value of the underlying asset at the commencement date) to accrete interest income on the lease receivable and unguaranteed residual asset. Therefore, the portion of the deferred selling profit that is amortized each period equals the difference between total periodic interest income recognized on the net investment in the lease less the periodic interest income earned on the lease receivable and unguaranteed residual asset. See Example 2 for illustration.

After the commencement date, a lessor recognizes the following in the statement of operations:

- ▶ Interest income on the net investment in the lease using the rate implicit in the lease (as discussed above).
- ▶ Variable lease payments that are not included in the net investment in the lease as income in the period when the changes in facts and circumstances on which the variable lease payments are based occur.
- ▶ Impairment (or credit losses) on the net investment in the lease.

The net investment in the lease is not remeasured after the commencement date except in a lease modification that is not accounted for as a separate contract. See Modification Section in this Chapter for additional discussion.

### 6.5.3 ACCOUNTING AT THE END OF LEASE TERM

At the end of the lease term, a lessor reclassifies the net investment in the lease to the appropriate category of asset (for example, property, plant, and equipment) in accordance with other GAAP, measured at the carrying amount of the net investment in the lease. The lessor then accounts for the underlying asset that was the subject of a lease in accordance with other Topics, such as ASC 360.

### 6.5.4 ACCOUNTING FOR LEASE TERMINATION

If a direct financing lease is terminated before the end of the lease term, a lessor:

- ▶ Tests the net investment in the lease for impairment or credit losses under ASC 310 or ASC 326-20, as applicable.
- ▶ Reclassifies the net investment in the lease to the appropriate category of asset in accordance with other GAAP, measured at the sum of the carrying amounts of the lease receivable (less any amounts still expected to be received by the lessor) and the residual asset.
- ▶ Accounts for the underlying asset that was the subject of the lease in accordance with other GAAP, such as ASC 360.

## EXAMPLE 2 - DIRECT FINANCING LEASE

### FACTS

- ▶ Assume the same facts as in Example 1A above, except that the \$35,000 residual value guarantee is provided by a third party, not by Lessee.
- ▶ Collectibility of the lease payments and any amount necessary to satisfy the third-party residual value guarantee are probable.

### ANALYSIS

#### Accounting at the commencement date

- ▶ For this Example, the following interest rate information will be needed to (1) assess classification of the lease as a sales-type lease, (2) if not a sales-type lease, to assess classification as a direct financing lease, and (3) if classified as a direct financing lease, to account for the net investment in the direct financing lease:

|                            | Step 1: Calculate rate implicit in the lease as defined | Step 2: Add initial direct costs to the fair value of the underlying asset | Step 3: Replace fair value of the underlying asset by its carrying amount |
|----------------------------|---|--|---|
|                            | PMT   | PMT  | PMT   |
| Year 0                     | (170,000)   | (172,000)  | (152,000)   |
| Year 1                     | 25,000  | 25,000   | 25,000  |
| Year 2                     | 25,000  | 25,000   | 25,000  |
| Year 3                     | 25,000  | 25,000   | 25,000  |
| Year 4                     | 25,000  | 25,000   | 25,000  |
| Year 5                     | 25,000  | 25,000   | 25,000  |
| Year 6                     | 80,000  | 80,000   | 80,000  |
| Undiscounted PMTs          | 205,000   | 205,000  | 205,000   |
| Rate implicit in the lease | 4.68%<br>“Sales-Type Classification Rate”*              | 4.38%<br>“DFL Classification Rate”**                                       | 7.68%<br>“Direct Financing Rate”***                                       |

\* The Sales-Type Classification Rate is the rate that is used to assess whether the lease qualifies as a sales-type lease under ASC 842-10-25-2(d). It is the same rate as calculated in Example 1A based on the fair value of the underlying asset at the commencement date, the lease payments to be received over the lease term, and the expected amount of the residual asset at the end of the lease term. Initial direct costs are excluded since the fair value of the underlying asset is different than its carrying value.

\*\* The Direct Financing Lease (“DFL”) Classification Rate is the rate that is used to assess whether the lease qualifies as a direct financing lease under ASC 842-10-25-3(b)(1). It is calculated like the Sales-Type Rate, except that initial direct costs are deferred (i.e., added to the fair value of the underlying asset). This rate will also be used to initially and subsequently measure the lease receivable and the unguaranteed residual asset.

\*\*\* The Direct Financing Rate is the rate used for initial and subsequent measurement of the net investment in the lease. It is calculated like the DFL Classification Rate, except that the carrying amount of the asset is used, rather than fair value, since the selling profit is deferred and recognized as part of the subsequent measurement of the net investment in the lease.

- To determine if the lease qualifies as a sales-type lease, J.R.E calculates the present value of the lease payments at the commencement date using the Sales-Type Classification Rate. The lease payments include only the annual payments of \$25,000 made by Lessee. Because the residual value guarantee is provided by a third party, it is not considered in the sales-type lease classification test.

| <b>PMT</b>               |                |
|--------------------------|----------------|
| Year 1                   | 25,000         |
| Year 2                   | 25,000         |
| Year 3                   | 25,000         |
| Year 4                   | 25,000         |
| Year 5                   | 25,000         |
| Year 6                   | 25,000         |
| <b>Undiscounted PMTs</b> | <b>150,000</b> |
| <b>PV (4.68%) =</b>      | <b>128,200</b> |

- J.R.E concludes that none of the criteria for classifying the lease as a sales-type lease are met because:
- The lease does not transfer ownership of the equipment to Lessee nor grant it a purchase option.
  - The lease term is not for the major part of the remaining economic life of the underlying asset ( $6/10 = 60\%$ ).
  - The present value of the lease payments does not amount to substantially all of the fair value of the equipment ( $128,200/170,000 = 75\%$ ). Note: this calculation does not consider the residual value guarantee provided by the *third party*.
  - The underlying asset is not of a specialized nature and it will have alternative uses to the lessor at the end of the lease term.
- J.R.E then assesses classification of the lease as a direct financing lease, using the DFL Classification Rate:

| <b>PMT</b>               |   |
|--------------------------|---|
| Year 1                   | 25,000  |
| Year 2                   | 25,000  |
| Year 3                   | 25,000  |
| Year 4                   | 25,000  |
| Year 5                   | 25,000  |
| Year 6                   | 60,000 (25,000 lease payment + 35,000 3 <sup>rd</sup> party residual value guarantee) |
| <b>Undiscounted PMTs</b> | <b>185,000</b>  |
| <b>PV (4.38%) =</b>      | <b>156,532</b>  |

- J.R.E classifies the lease as a direct financing lease because:
- The sum of the present value of the lease payments and the present value of the third-party residual value guarantee amounts to substantially all of the fair value of the equipment ( $156,532/170,000 = 92\%$ ).
  - It is probable J.R.E will collect the lease payments and any amount necessary to satisfy the third-party residual value guarantee.
  - ASC 842-10-25-3A on variable lease payments not based on an index or a rate does not apply.

- ▶ Therefore, at the commencement date, J.R.E derecognizes the equipment for \$150,000 and recognizes a net investment in the lease of \$152,000 measured using the Direct Financing Rate:

|                          | PMT  |
|--------------------------|--|
| Year 1                   | 25,000   |
| Year 2                   | 25,000   |
| Year 3                   | 25,000   |
| Year 4                   | 25,000   |
| Year 5                   | 25,000   |
| Year 6                   | 80,000      (25,000 lease payment + 55,000 estimated residual value) |
| <b>Undiscounted PMTs</b> | <b>205,000</b>   |
| <b>PV (7.68%) =</b>      | <b>152,000</b>   |



The net investment in the lease equals the carrying value of the underlying asset of \$150,000 plus the initial direct costs of \$2,000. There are no prepaid lease payments.

- ▶ The net investment in the lease includes the following components:

- Lease receivable of \$156,532 (which is the present value of the lease payments and the third-party residual value guarantee, discounted using the *DFL Classification Rate of 4.38%*),
- Unguaranteed residual asset of \$15,468 (which is the difference between the estimated residual value of \$55,000 and the third-party residual value guarantee of \$35,000, also discounted at 4.38%)
- Deferred selling profit of \$20,000, which is calculated as follows:

|  |                |
|--|----------------|
| Lease receivable, minus  | 156,532        |
| Carrying value of the equipment, net of unguaranteed residual value, minus | (134,532)      |
| Deferred initial direct costs  | <u>(2,000)</u> |
| <b>Deferred selling profit</b>   | <b>20,000</b>  |



The sum of the lease receivable, unguaranteed residual asset, and deferred selling profit equals the carrying amount of the net investment in the lease of \$152,000.

- ▶ J.R.E records the following journal entry at the commencement date:

|                                 | \$      | \$      |
|---------------------------------|---------|---------|
| Dr. Net investment in the lease | 152,000 |         |
| Cr. Equipment - carrying value  |         | 150,000 |
| Cr. Cash (or prepaid asset)     |         | 2,000   |

*To derecognize the underlying asset and recognize a net investment in the direct financing lease.*

Subsequent measurement (assuming no modification)

- J.R.E increases the carrying amount of the net investment in the lease for interest income using the Direct Financing Rate of 7.68% and reduces it to reflect the lease payments collected. For example, J.R.E records the following journal entry at the end of Year 1:

|                                 | \$     | \$     |
|---------------------------------|--------|--------|
| Dr. Cash                        | 25,000 |        |
| Cr. Net investment in the lease |        | 13,331 |
| Cr. Interest income*            |        | 11,669 |

\* Net investment in the lease of \$152,000 multiplied by the Direct Financing Rate of 7.68%

- J.R.E subsequently measures the net investment in the lease using the Direct Financing Rate of 7.68%, assuming no modifications throughout the lease term:

|        | <b>Beg.<br/>Balance</b> | <b>Interest<br/>(7.68%)</b> | <b>PMT</b> | <b>Ending<br/>Balance</b> |
|--------|-------------------------|-----------------------------|------------|---------------------------|
| Year 1 | 152,000                 | 11,669                      | (25,000)   | 138,669                   |
| Year 2 | 138,669                 | 10,646                      | (25,000)   | 124,315                   |
| Year 3 | 124,315                 | 9,544                       | (25,000)   | 108,859                   |
| Year 4 | 108,859                 | 8,357                       | (25,000)   | 92,217                    |
| Year 5 | 92,217                  | 7,080                       | (25,000)   | 74,296                    |
| Year 6 | 74,296                  | 5,704                       | (25,000)   | 55,000                    |

- In accordance with ASC 842-30-30-1, and for disclosure purposes, J.R.E calculates the separate components of the net investment in the lease as follows:

Lease receivable (using the DFL Classification Rate):

|        | <b>Beg.<br/>Balance</b> | <b>Interest<br/>(4.38%)</b> | <b>PMT</b> | <b>Ending<br/>Balance</b> |
|--------|-------------------------|-----------------------------|------------|---------------------------|
| Year 1 | 156,532                 | 6,850                       | (25,000)   | 138,382                   |
| Year 2 | 138,382                 | 6,056                       | (25,000)   | 119,438                   |
| Year 3 | 119,438                 | 5,227                       | (25,000)   | 99,665                    |
| Year 4 | 99,665                  | 4,361                       | (25,000)   | 79,026                    |
| Year 5 | 79,026                  | 3,458                       | (25,000)   | 57,484                    |
| Year 6 | 57,484                  | 2,516                       | (25,000)   | 35,000                    |

Unguaranteed residual value (using the DFL Classification Rate):

|        | <b>Beg.<br/>Balance</b> | <b>Interest<br/>(4.38%)</b> | <b>Ending<br/>Balance</b> |
|--------|-------------------------|-----------------------------|---------------------------|
| Year 1 | 15,468                  | 677                         | 16,145                    |
| Year 2 | 16,145                  | 706                         | 16,851                    |
| Year 3 | 16,851                  | 737                         | 17,588                    |
| Year 4 | 17,588                  | 770                         | 18,358                    |
| Year 5 | 18,358                  | 803                         | 19,161                    |
| Year 6 | 19,161                  | 839                         | 20,000                    |

Deferred selling profit:

|               | <b>Beg.<br/>Balance</b> | <b>Profit Earned*</b> | <b>Ending<br/>Balance</b> |
|---------------|-------------------------|-----------------------|---------------------------|
| <b>Year 1</b> | (20,000)                | 4,142                 | (15,858)                  |
| <b>Year 2</b> | (15,858)                | 3,884                 | (11,974)                  |
| <b>Year 3</b> | (11,974)                | 3,580                 | (8,394)                   |
| <b>Year 4</b> | (8,394)                 | 3,226                 | (5,168)                   |
| <b>Year 5</b> | (5,168)                 | 2,818                 | (2,350)                   |
| <b>Year 6</b> | (2,350)                 | 2,350                 | —                         |

\* The portion of the deferred selling profit recognized in the income statement each period equals the difference between the interest income recognized on the net investment in the lease during the period and the sum of the interest income earned on the lease receivable and the unguaranteed residual asset during that same period.

For example, in Year 1:

- Interest income on the net investment in the lease is \$11,669 (initial net investment in the lease of \$152,000 x Direct Financing Rate of 7.68%)
- Amortization of deferred selling profit is \$4,142 and is equal to interest income of \$11,669 minus interest recognized on the lease receivable of \$6,850 minus interest recognized on the unguaranteed residual asset of \$677.



At the end of the lease term, the net investment in the lease equals the estimated residual value of the asset of \$55,000, the lease receivable equals the third party residual value guarantee of \$35,000, the unguaranteed residual asset is the difference between \$55,000 and \$35,000, and the deferred selling profit balance is zero (i.e., all selling profit has been recognized over the lease term).

- The following summarizes interest income recognized in profit or loss throughout the lease term:

|               |        |
|---------------|--------|
| <b>Year 1</b> | 11,669 |
| <b>Year 2</b> | 10,646 |
| <b>Year 3</b> | 9,544  |
| <b>Year 4</b> | 8,357  |
| <b>Year 5</b> | 7,080  |
| <b>Year 6</b> | 5,704  |
| <b>Total</b>  | 53,000 |



Total interest income recognized is \$53,000 and represents the difference between (1) the undiscounted lease payments plus the expected residual value of the asset at the end of the lease term of \$205,000, and (2) the carrying value of the underlying asset at the commencement date of \$150,000 plus initial direct costs of \$2,000.

- At the end of the lease term, J.R.E reclassifies the net investment in the lease of \$55,000 to property, plant and equipment and then accounts for it under ASC 360.

## 6.6 OPERATING LEASES

### 6.6.1 Recognition and Initial Measurement

The accounting by a lessor for operating leases under ASC 842 is the same as the accounting under ASC 840. A lessor does not derecognize the underlying asset at the commencement date, and it defers any initial direct costs as a separate asset.

### 6.6.2 Subsequent Measurement

After the commencement date, a lessor continues to measure the underlying asset subject to an operating lease, including testing it for impairment, in accordance with other Topics, such as ASC 360 on property, plant and equipment.

A lessor recognizes the following lease income in profit or loss, depending on whether collectibility of the lease payments plus any amount necessary to satisfy a residual value guarantee provided by either the lessee or a third party is probable:

| COLLECTIBILITY IS PROBABLE   | COLLECTIBILITY IS <u>NOT</u> PROBABLE   |
|--|---|
| <p>Recognize the following:</p> <ul style="list-style-type: none"> <li>▶ The lease payments as income over the lease term typically on a straight-line basis, unless another systematic and rational basis is more representative of the pattern in which benefit is expected to be derived from the use of the underlying asset (see below for additional discussion).</li> <li>▶ Variable lease payments in the period in which the changes in facts and circumstances on which these payments are based occur.</li> </ul> | <p>Lease income is limited to the lesser of:</p> <ul style="list-style-type: none"> <li>▶ The amounts described in the left column, and</li> <li>▶ The lease payments, including variable lease payments, that have been collected from the lessee (i.e., a cash basis).</li> </ul> |

Initial direct costs are recognized as an expense over the lease term on the same basis as the lease income.



#### PATTERN OF BENEFITS EXPECTED FROM USE OF UNDERLYING ASSET

ASC 842 considers the right to control the use of the underlying asset as the equivalent of physical use. That is, if the lessee controls the use of the underlying asset, recognition of lease income is not affected by the extent of the lessee's use of the underlying asset.

The lessor should also reassess changes in collectibility after the commencement date. If collectibility of the remaining lease payments plus amounts necessary to satisfy a residual value guarantee becomes probable, then, any difference between the cumulative lease income that would have been recognized on an accrual basis and cumulative lease income that has been recognized on a cash basis is recognized as a current-period adjustment to lease income.

See Example 1, Case D at ASC 842-30-55-40 through 55-42 for an illustration of a lease classified as an operating lease when collectibility of the lease payments and amounts to satisfy a residual value guarantee is not probable at the commencement date.

See Section 6.8.2 for additional discussion on collectibility and impairment considerations for operating leases.

### EXAMPLE 3 - OPERATING LEASE

#### FACTS

- ▶ Assume the same facts as in Example 1A above, except that no residual value guarantee is provided either by Lessee or an unrelated third party.
- ▶ Collectibility of the lease payments is considered probable at the commencement date and throughout the lease term.

#### ANALYSIS

- ▶ In order to determine whether to classify the lease as a sales-type lease, J.R.E calculates the present value of the lease payments at the commencement date, using the rate implicit in the lease of 4.68% (see Example 1A for calculation):

| PMT                      |                |
|--------------------------|----------------|
| Year 1                   | 25,000         |
| Year 2                   | 25,000         |
| Year 3                   | 25,000         |
| Year 4                   | 25,000         |
| Year 5                   | 25,000         |
| Year 6                   | 25,000         |
| <b>Undiscounted PMTs</b> | <b>150,000</b> |
| <b>PV (4.68%) =</b>      | <b>128,200</b> |

- ▶ J.R.E concludes that none of the criteria for classifying the lease as a sales-type lease are met because:
  - The lease does not transfer ownership of the equipment to Lessee nor grant it a purchase option.
  - The lease term is not for a major part of the remaining economic life of the underlying asset ( $6/10 = 60\%$ ).
  - The present value of the lease payments does not amount to substantially all of the fair value of the equipment ( $128,200/170,000 = 75\%$ ).
  - The underlying asset is not of a specialized nature and will have alternative uses to the lessor at the end of the lease term.
- ▶ In addition, the lease does not qualify as a direct financing lease since there is no third-party residual value guarantee. Accordingly, the lease is classified as an operating lease.
- ▶ J.R.E initially recognizes the amount of initial direct costs (\$2,000) as a separate asset.
- ▶ J.R.E continues to measure the equipment in accordance with ASC 360, *Property, Plant and Equipment*.
- ▶ At the end of Years 1-6, J.R.E records the following entries (assuming the lease is not modified or terminated and the assessment of collectibility as probable does not change) to reflect the periodic lease income and amortization of the deferred initial direct costs:

|   | \$     | \$     |
|---|--------|--------|
| Dr. Cash                                | 25,000 |        |
| Cr. Lease income                        |        | 25,000 |
| Dr. Operating expenses                  | 333    |        |
| Cr. Other assets - initial direct costs |        | 333    |

## 6.7 MODIFICATIONS

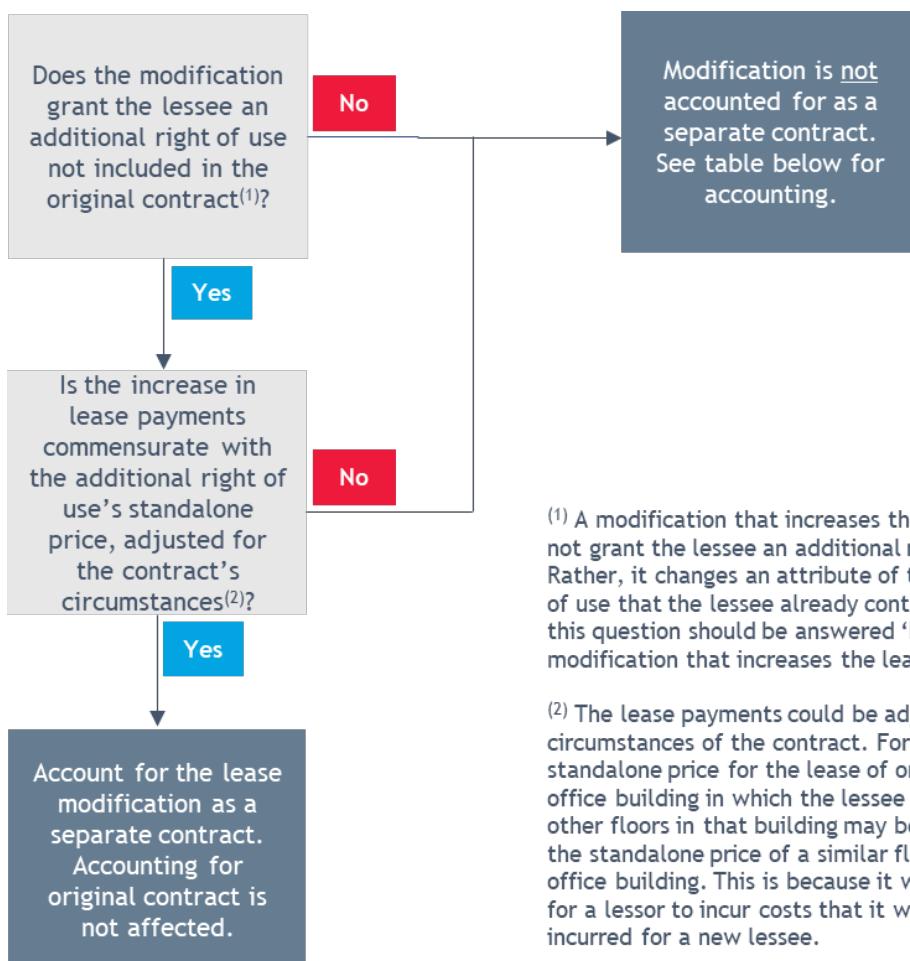
A lease modification is a change to the terms and conditions of the contract that results in a change in the scope of, or the consideration for, the lease. For example, a lease could be modified to add or terminate the right to use one or more underlying assets, it could be modified to extend or shorten the contractual lease term, and so forth.

A lessor is required to account for the modification at the date that the lease modification is approved by both the lessee and the lessor (the effective date of the modification under ASC 842).

A lessor also accounts for the following events as modifications:

- ▶ When the lessee exercises a renewal or purchase option included in the original contract that the lessor previously determined was not reasonably certain of exercise,
- ▶ When the lessee exercises a termination option included in the original contract that the lessor had determined the lessee was not reasonably certain to exercise,
- ▶ When the lessee takes control over the use of an additional underlying asset under a master lease agreement that permits (i.e., does not require) the lessee to gain control over the use of additional underlying assets during the term of the agreement.

In accounting for lease modifications, ASC 842 differentiates between modifications that result in a separate contract and which therefore do not affect the accounting for the original contract, and other modifications that should be accounted for as part of the original contract. That determination can be made by using the following steps:



<sup>(1)</sup> A modification that increases the lease term does not grant the lessee an additional right-of-use. Rather, it changes an attribute of the original right of use that the lessee already controls. Accordingly, this question should be answered 'No' for a modification that increases the lease term.

<sup>(2)</sup> The lease payments could be adjusted for the circumstances of the contract. For example, the standalone price for the lease of one floor of an office building in which the lessee already leases other floors in that building may be different from the standalone price of a similar floor in a different office building. This is because it was not necessary for a lessor to incur costs that it would have incurred for a new lessee.

If a modification is not accounted for as a separate contract, a lessor:

- ▶ Reassesses the lease term and any purchase option. See Chapter 4 for additional details on assessing whether renewal options, purchase options and termination options are reasonably certain to be exercised.
- ▶ Remeasures and reallocates the remaining consideration in the contract. See Chapter 4 for additional details on measuring lease payments, and Chapter 3 for additional details on allocating consideration.
- ▶ Reassesses lease classification based on the facts and circumstances (and the modified terms and conditions) as of the effective date of the modification (for example, using the fair value and remaining economic life of the underlying asset at that date). See Chapter 4 for additional details on determining lease classification.

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

#### BDO INSIGHTS – MODIFICATION CONSIDERATIONS RELATED TO MASTER LEASE AGREEMENTS

Master lease agreements typically provide a lessee with the right to use multiple underlying assets. If a master lease agreement permits the lessee to gain control over the use of additional underlying assets during the contract's term but does not obligate the lessee to do so, when the lessee takes control over the use of an additional asset, it should be accounted for as a lease modification as discussed in this section.

In contrast, a master lease agreement that specifies a minimum number of units or dollar value of equipment does not result in a lease modification when the lessee obtains control over the use of those additional assets. Rather, there may be separate lease components in the contract, and potentially multiple commencement dates.

A lessee and a lessor may also modify a master lease agreement to early terminate the right to use some of the assets (lease components) in the master lease agreement. Even if the modification does not change the economics of the remaining lease components, the lessor should apply modification accounting, including reassessing classification and adjusting the accounting for the remaining lease components. This requires the lessor to reconsider inputs for classification and measurement purposes, such as the economic life and fair value of the underlying assets and the discount rate for the lease. In 2020, the FASB proposed changes to the modification guidance following stakeholder feedback questioning the usefulness and costs of applying modification accounting to modifications reducing the scope of certain arrangements, such as master lease agreements. However, the FASB later abandoned the project and, accordingly, the guidance remains unchanged.

#### BDO INSIGHTS – MODIFICATIONS RELATED TO VARIABLE LEASE PAYMENTS THAT ARE NOT BASED ON AN INDEX OR A RATE

Variable lease payments that are not based on an index or a rate, such as payments based on a percentage of sales of the lessee, are excluded from the definition of lease payments and are thus excluded from the consideration in the contract under ASC 842. However, if the lessee and lessor modify the agreement to change such payments, such as by lowering the percentage applied to sales of the lessee or to add variable lease payments not based on an index or a rate, we believe the lessee should apply the modification framework discussed in this section. The lease modification guidance under ASC 842 is not limited to changes in the *consideration in the contract* (as defined in ASC 842), but rather applies more broadly to **any** changes in the consideration for a lease. In other words, any modification that results in changes in the payments required by the lease, whether those meet the definition of lease payments or not, should be evaluated under the modification guidance.



### SALES-TYPE LEASES THAT ARE MODIFIED AFTER ADOPTION OF ASU 2021-05

As discussed in Section 6.2, before the adoption of ASU 2021-05 a lessor may have recognized a selling loss (or “day-one loss”) for a sales-type lease due to variable lease payments not based on an index or a rate, such as payments based on energy produced by a solar farm. ASU 2021-05 changed those classification requirements and now requires a lessor to classify a lease as operating if:

- ▶ the lease includes variable lease payments not based on an index or a rate, and
- ▶ classifying the lease as sales-type would result in a selling loss

We believe a lessor that has adopted ASU 2021-05 should apply those updated lease classification requirements to all leases that are modified on or after its adoption of ASU 2021-05, including leases previously classified as sales-type, even if the lessor previously recognized a selling loss at the commencement date. In determining whether the modified lease would result in a selling loss (as defined in the Glossary) if classified as a sales-type lease, the lessor should use the carrying amount of the net investment in the lease immediately before the effective date of the modification as the carrying amount of the underlying asset, which is consistent with the guidance in ASC 842-10-25-16(b) on modifications to direct financing leases.



### RELIEF IS PROVIDED FOR REFERENCE RATE REFORM

ASU 2020-04 provides optional expedients and exceptions for applying U.S. GAAP to contracts and transactions affected by the reference rate reform (that is, discontinuation of LIBOR or other reference rate expected to be discontinued).

Accordingly, modifications to contracts within the scope of ASC 842 that change the reference rate may be accounted for as a continuation of the existing contract with no reassessment of lease classification and discount rate, and no remeasurement of lease payments that otherwise would be required for modifications not accounted for as separate contracts. Instead, the change in reference rate is treated as variable lease payments that were based on the reference rate in the original lease.

However, to qualify for the optional expedient, other terms being concurrently modified, if any, must be related to the replacement of a reference rate because of reference rate reform. For example, the following changes are not eligible for the expedient because they are deemed unrelated to the replacement of a reference rate:

- ▶ Changes to the contractual term of the lease
- ▶ Additions or terminations of right-to-use underlying assets
- ▶ Changes to renewal, termination or purchase options

See ASC 848-20-15-2 through 15-6 for additional information about scope of the expedient, and ASC 848-20-35-11 and 35-12 for application of the expedient to leases by lessors.

The accounting for modifications that are not accounted for as a separate contract is summarized in the following table depending on how classification changes (and assuming there continues to be a lease after the modification):

| MODIFICATION TYPE  | ACCOUNTING CONSIDERATIONS   |
|--|---|
| <b>Operating lease to operating lease</b>  | <ul style="list-style-type: none"> <li>▶ Account for the modification as a termination of the existing lease and creation of a new lease that commences on the effective date of the modification.</li> <li>▶ Consider any prepaid or accrued lease rentals related to the original lease as part of the lease payments for the modified lease.</li> <li>▶ See Example 20 at ASC 842-10-55-190 through 55-193 for illustration.</li> </ul>  |
| <b>Operating lease to sales-type or direct financing lease</b>   | <ul style="list-style-type: none"> <li>▶ Account for the modification as a termination of the existing lease and creation of a new lease that commences on the effective date of the modification.</li> <li>▶ Recognize a net investment in the modified lease and derecognize both the underlying asset and any deferred rent liability or accrued rent asset (which adjusts the selling profit or loss). <ul style="list-style-type: none"> <li>• If the modified lease is classified as a sales-type lease, the selling profit or loss is recognized in profit or loss at the effective date of the modification. See Example 21, Case A at ASC 842-10-55-194 through 55-197 for an illustration.</li> <li>• If the modified lease is classified as a direct financing lease, any selling loss is recognized in profit or loss at the effective date of the modification. However, any selling profit is deferred and included in the measurement of the net investment in the lease. See Example 21, Case B at ASC 842-10-55-198 through 55-200 for an illustration.</li> </ul> </li> <li>▶ After the effective date of the modification, a lessor accounts for the modified lease in the same manner as any other sales-type or direct financing lease.</li> </ul> |
| <b>Direct financing lease to direct financing lease</b><br><b>Sales-type lease to sales-type or direct financing lease</b> | <ul style="list-style-type: none"> <li>▶ Adjust the discount rate for the modified lease so that the initial net investment in the modified lease equals the carrying amount of the net investment in the original lease immediately before the effective date of the modification.</li> <li>▶ See Example 22, Case A at ASC 842-10-55-201 through 55-205 for an illustration.</li> </ul>   |
| <b>Direct financing lease to sales-type lease</b>  | <ul style="list-style-type: none"> <li>▶ Account for the modified lease under the guidance for sales-type leases. The effective date of the modification is the commencement date of the modified lease.</li> <li>▶ Calculate the selling profit or selling loss on the lease as the difference between the fair value of the underlying asset at the effective date of the modification and the carrying amount of the net investment in the original lease immediately before that date.</li> <li>▶ See Example 22, Case B at ASC 842-10-55-206 and 55-207 for an illustration. See also Example 4 below.</li> </ul>  |
| <b>Direct financing or sales-type lease to operating lease</b>   | <ul style="list-style-type: none"> <li>▶ The carrying amount of the underlying asset equals the net investment in the original lease immediately before the effective date of the modification.</li> <li>▶ See Example 22, Case C at ASC 842-10-55-208 and 55-209 for an illustration. See also Example 5 below.</li> </ul>   |

#### EXAMPLE 4 - MODIFICATION OF A DIRECT FINANCING LEASE TO A SALES-TYPE LEASE

##### FACTS

- ▶ Assume the same facts as in Example 2 apply, in which J.R.E entered into a lease of non-specialized equipment with Lessee for 6 years, with annual lease payments of \$25,000 payable at the end of each year, and with a third-party residual value guarantee of \$35,000. The lease was classified as a direct financing lease at the commencement date. Also assume the following:
- ▶ At the end of Year 1 of the lease, J.R.E and Lessee agree to extend the lease term by two years.
- ▶ The annual lease payments in each of Years 7-8 are \$30,000.
- ▶ The fair value of the equipment at the effective date of the modification is \$162,000.
- ▶ The carrying amount of the net investment in the lease immediately before the modification is \$138,669.
- ▶ The estimated residual value of the equipment at the end of the modified lease is \$20,000, of which \$8,000 is guaranteed by a third-party unrelated to Lessee or J.R.E.
- ▶ At the effective date of the modification, the remaining economic life of the equipment is 9 years.
- ▶ There are no initial direct costs related to the modification.

##### ANALYSIS

- ▶ The modification does not grant Lessee an additional right of use but rather alters Lessee's already obtained right to use the equipment. The modification is not accounted for as a separate contract.
- ▶ Because the lease term is for a major part (in this case 78%) of the remaining economic life of the equipment at the effective date of the modification, J.R.E classifies the lease as a sales-type lease (note that in this example the lease payments are also substantially all of the fair value of the equipment). ASC 842-10-25-3A on variable lease payments not based on an index or a rate does not apply.
- ▶ The rate implicit in the modified lease is calculated as shown below:

| End of   | PMT          |
|--|--------------|
| Year 1   | (162,000)    |
| Year 2   | 25,000       |
| Year 3   | 25,000       |
| Year 4   | 25,000       |
| Year 5   | 25,000       |
| Year 6   | 25,000       |
| Year 7   | 30,000       |
| Year 8   | 50,000       |
| (30,000 lease payment + 20,000 estimated residual value) |              |
| <b>Rate implicit in the lease</b>                        | <b>5.64%</b> |

- ▶ At the effective date of the modification, J.R.E recognizes a net investment in the sales-type lease of \$162,000 (the fair value of the underlying equipment at that date). In addition, it derecognizes the outstanding balance of the net investment in the direct financing lease of \$138,669. The difference is recognized as a selling profit.

|  | \$      | \$      |
|--|---------|---------|
| Dr. Net investment in sales-type lease       | 162,000 |         |
| Cr. Net investment in direct financing lease |         | 138,669 |
| Cr. Selling profit                           |         | 23,331  |

- ▶ The net investment in the lease consists of a lease receivable of \$153,826 (present value of lease payments and third-party residual value guarantee) and unguaranteed residual asset of \$8,174, all discounted at 5.64%.
- ▶ Following the modification, J.R.E accounts for the sales-type lease in the same manner as any other sales-type lease, as illustrated in Examples 1A and 1B.

### EXAMPLE 5 - MODIFICATION OF A SALES-TYPE LEASE TO AN OPERATING LEASE

#### FACTS

- ▶ Assume the same facts as in Example 1A apply, in which J.R.E entered into a lease of non-specialized equipment with Lessee for 6 years, with annual lease payments of \$25,000 payable at the end of each year, and in which Lessee provided a residual value guarantee of \$35,000. The lease was classified as a sale-type lease at the commencement date. Also assume the following:
- ▶ At the end of Year 1 of the lease, J.R.E and Lessee agree to shorten the lease term by two years.
- ▶ The annual lease payments in each of Years 2-4 increase to \$30,000 due at the end of each year.
- ▶ The fair value of the equipment at the effective date of the modification is \$162,000.
- ▶ The carrying amount of the net investment in the lease immediately before the modification is \$152,956.
- ▶ J.R.E expects that the residual value of the equipment at the end of the remaining 3-year lease term will be \$90,000, of which \$25,000 is guaranteed by Lessee.
- ▶ At the effective date of the modification, the remaining economic life of the equipment is 9 years.
- ▶ There are no initial direct costs related to the modification.

#### ANALYSIS

- ▶ As the modification does not grant Lessee an additional right-of-use, it is not accounted for as a separate contract.
- ▶ The rate implicit in the modified lease is calculated as shown below:

| End of                            | PMT   |
|-----------------------------------|---|
| Year 1                            | (162,000)   |
| Year 2                            | 30,000  |
| Year 3                            | 30,000  |
| Year 4                            | 120,000      (30,000 lease payment + 90,000 estimated residual value) |
| <b>Rate Implicit in the lease</b> | <b>4.33%</b>  |

- ▶ J.R.E concludes that none of the criteria for classifying the lease as a sales-type lease are met because:
  - The lease does not transfer ownership of the equipment to Lessee nor grant it a purchase option.
  - The lease term is not for a major part of the remaining economic life of the underlying asset ( $3/9 = 33\%$ ).
  - The present value of the lease payments plus Lessee's residual value guarantee, discounted at 4.33%, does not amount to substantially all of the fair value of the equipment at the effective date of the modification ( $104,756/162,000 = 65\%$ ).
  - The underlying asset is not of a specialized nature and will have alternative uses to the lessor at the end of the lease term.
- ▶ As there is no residual value guarantee provided by a third-party, J.R.E classifies the modified lease as an operating lease in accordance with ASC 842-10-25-3(b).
- ▶ J.R.E therefore recognizes the equipment at the carrying amount of the net investment in the lease immediately before the modification:

|  | \$ | \$      |
|--|----|---------|
| Dr. Equipment                          |    | 152,956 |
| Cr. Net investment in sales-type lease |    | 152,956 |

- ▶ If collectability of the lease payments plus Lessee's residual value guarantee is considered probable, J.R.E will recognize the lease payments of \$90,000 ( $\$30,000 \times 3$  years) on a straight-line basis over the 3-year modified lease term, as well as depreciation on the equipment over its remaining useful life.

## 6.8 IMPAIRMENT

### 6.8.1 Net Investment in Sales-Type and Direct Financing Leases

A lessor determines the impairment (or loss allowance) related to net investment in sales-type and direct financing leases and records any impairment (or loss allowance) in accordance with ASC 310 on receivables (as described in paragraphs 310-10-35-16 through 35-30), or ASC 326-20 on financial instruments measured at amortized cost when adopted. In determining the loss allowance for a net investment in the lease, a lessor considers the collateral relating to the net investment in the lease, which represents the cash flows that the lessor would expect to receive (or derive) from the lease receivable and the unguaranteed residual asset during and following the end of the remaining lease term.

In some cases, the contractual term over which the expected credit losses are measured in accordance with ASC 326-20-30-6 may differ from the lease term determined in accordance with ASC 842-10-30-1, due to certain requirements in both standards that may shorten or extend the contractual term. For example, consideration of lease extension options under ASC 842 may not be reflected in the contractual term used for purposes of ASC 326 unless certain conditions are met. In order to address any potential differences between the lease term and the contractual term under both standards, the FASB issued ASU 2020-03, *Codification Improvements to Financial Instruments* to clarify that lessors should use the lease term determined under ASC 842 as the contractual term for the net investment in leases for purposes of measuring credit losses under ASC 326.

### 6.8.2 Operating Leases

Because lessors do not derecognize the underlying asset associated with an operating lease, there is no net investment in the lease to be assessed for impairment. Instead, the underlying asset continues to be assessed for impairment in accordance with the guidance in ASC 360-10-35.

Also, ASC 842-30-25-12 and 25-13 provide guidance for lessors on the impairment of operating lease receivables. That guidance establishes a collectibility constraint whereby lease income for operating leases is recognized on a straight-line basis (or other systematic basis) only when collectibility of the lease payments and any amounts due under residual value guarantees is probable. ASC 842-30 is silent as to whether a lessor can (or should) apply other GAAP for the impairment of its operating lease receivables. Before adoption of ASC 842, many lessors applied the guidance in ASC 310 on receivables and in ASC 450-20 on loss contingencies and recognized reserves on operating lease receivables. Operating lease receivables are outside the scope of ASC 326-20 on credit losses, but ASC 326-20 superseded the guidance in ASC 310.

Accordingly, questions arose as to whether the guidance in ASC 842-30 on lessor accounting is the complete set of accounting guidance that should be applied to operating lease receivables, or whether a lessor can (or should) continue to recognize reserves on operating lease receivables under other GAAP.

At a FASB meeting in July 2019, the FASB staff clarified that the following two approaches are acceptable and that lessors should provide appropriate disclosures to the extent material:

#### **Approach 1: Apply ASC 842-30 only**

Under this approach, a lessor applies ASC 842-30-25-12 and 25-13 only. At the lease commencement date and throughout the lease term, a lessor evaluates its operating leases for collectibility on an individual lease basis. The accounting under this approach is summarized in the following table.

| COLLECTIBILITY OF LEASE PAYMENTS PLUS<br>ANY AMOUNT NECESSARY TO SATISFY A<br>RESIDUAL VALUE GUARANTEE IS: | LESSOR RECOGNIZES LEASE INCOME:  |
|--|--|
| Probable   | <p>On a straight-line basis (or other systematic basis), plus variable lease payments in the period in which the changes in facts and circumstances on which these payments are based occur (i.e., on an accrual basis)</p>  |
| Not probable   | <p>At the lesser of:</p> <ul style="list-style-type: none"> <li>▶ Straight-line lease income (or other systematic basis), plus variable lease payments (i.e., the accrual basis described above)</li> <li>▶ Lease payments, including variable lease payments, collected (i.e., a cash basis)</li> </ul> |

When the assessment of collectibility changes during the lease term, a lessor recognizes on a cumulative basis as a current period adjustment to lease income the difference between (1) the accrual basis and (2) the cash basis, typically as either a credit to lease income (if collectibility becomes probable) or as a debit to lease income (if collectibility becomes not probable). The lessor would continue to assess collectibility throughout the remainder of the lease term and make further adjustments when the assessment of collectibility subsequently changes, also on a cumulative basis as a current period adjustment to lease income.

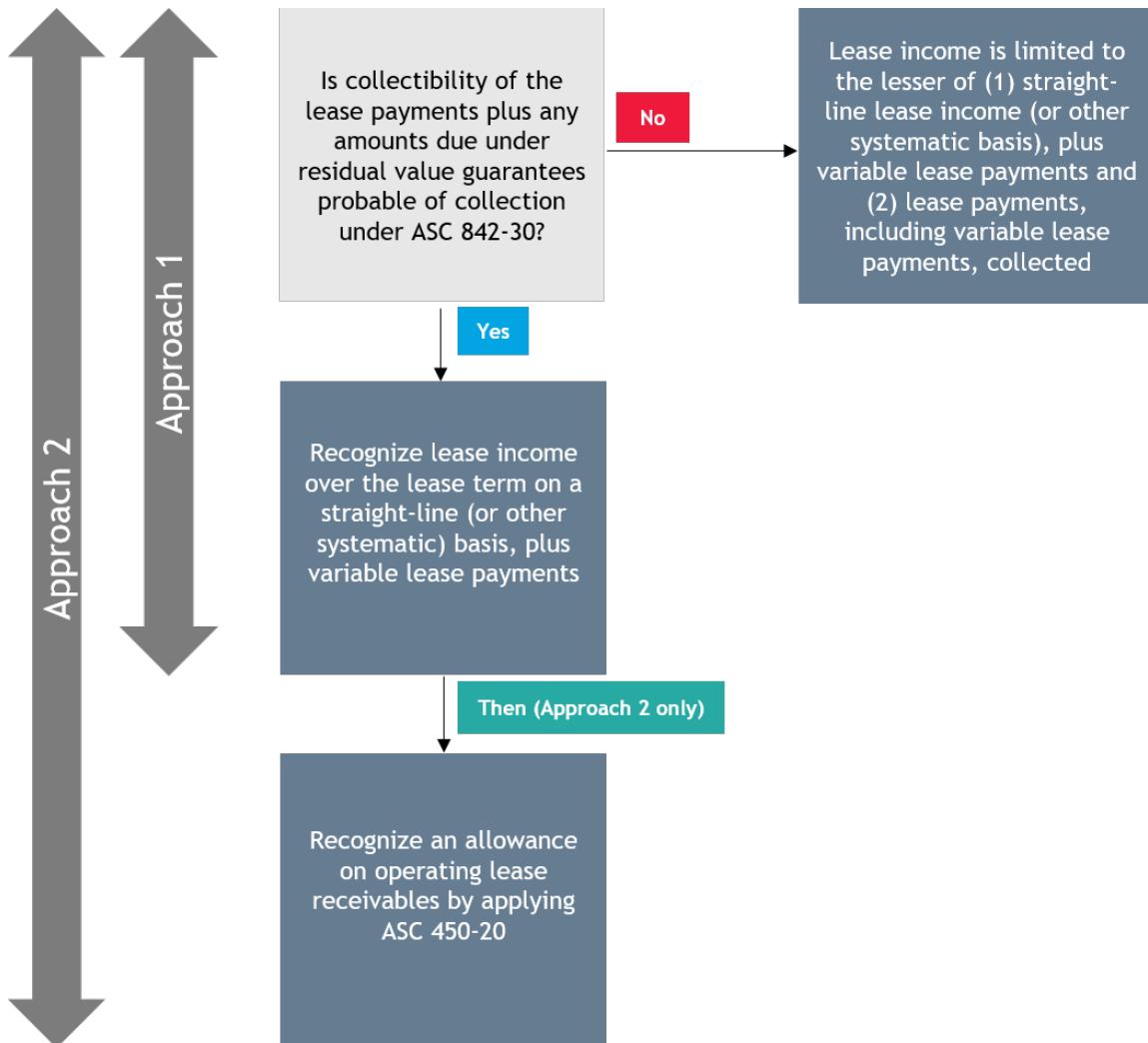
When collectibility is not probable, the lessor recognizes lease income subject to the constraint described above, which means that any lease receivable, if recognized, is fully reserved.

#### **Approach 2: Apply ASC 842-30 first, then apply ASC 450-20**

Under this method (like Method 1 above), a lessor assesses its operating lease receivables at the individual lease level under ASC 842-30 to determine whether collectibility of the lease payments (plus any amount necessary to satisfy a residual value guarantee) is probable. If collectibility is not probable, the lessor recognizes revenue subject to the cash basis constraint described in Method 1, which means that any lease receivable, if recognized, is fully reserved.

Once the collectibility assessment under ASC 842-30 is performed, a lessor then applies ASC 450-20. For operating leases that were considered probable of collection under ASC 842-30 and for which receivables are recognized, the lessor establishes and maintains a general allowance (reserve) in accordance with ASC 450-20, reflecting the lessor's expectation that a portion of the operating lease receivables will be uncollectible.

The following flowchart summarizes the initial considerations when applying Method 1 and Method 2 (note that the flowchart does not address changes in the assessment of collectibility):



The application of ASC 450-20 in addition to ASC 842-30 (i.e., Approach 2) has also resulted in additional practice issues, which are summarized in the following table.

| ISSUE   | CONSIDERATIONS  |
|---|---|
| <b>Should reserves recognized under ASC 450-20 be established through a reduction of lease income or through bad debt expense?</b>  | Based on discussions with the FASB staff, either approach is acceptable.  |
| <b>If reserves under ASC 450-20 are established through bad debt expense, how should a lessor account for a change in assessment of collectibility going from probable to not probable?</b> | <p>Broadly speaking, the FASB staff noted at a July 2019 FASB meeting that it is acceptable for the reserve accounting for operating lease receivables to be consistent with that currently applied for trade receivables (before ASC 326-20 becomes effective), as long as the lessor ceases recognizing lease income on a straight-line basis for an individual lease when collectibility no longer is probable for that lease.</p> <p>Specifically, we believe multiple approaches may be acceptable depending on the lessor's methodology for establishing and maintaining reserves under ASC 450-20, including:</p> <ul style="list-style-type: none"><li>▶ Writing off the gross receivable for the individual lease as an adjustment to lease income and separately adjusting the ASC 450-20 reserve as a bad debt expense adjustment (i.e., adjustments are made on a gross basis),</li><li>▶ Writing off the portion of the ASC 450-20 reserve attributable to the individual lease against the gross receivable for that lease and writing off the remaining balance of the lease receivable as an adjustment to lease income (i.e., adjustments are made on a net basis). This approach assumes that a lessor can identify on a systematic and rational basis the portion of the ASC 450-20 reserve attributable to individual leases.</li></ul> <p>Other approaches may be acceptable depending on the reserve methodology the lessor applied. In those circumstances, entities are encouraged to discuss with their accounting advisor or auditor the appropriateness of their methodology for recapturing amounts from the general reserve.</p> |

## 6.9 OTHER TRANSACTIONS

### 6.9.1 Sales of Lease Receivables

Transfers of lease receivables from sales-type and direct financing leases (which include the lease payments and amounts under residual value guarantees provided by either the lessee or a third-party) are subject to the requirements of ASC 860 on transfers and servicing. Unguaranteed residual assets however do not meet the definition of financial assets. If a lessor sells substantially all of the lease receivable associated with a sales-type lease or a direct financing lease and retains an interest in the unguaranteed residual asset, it no longer accretes the unguaranteed residual asset to its estimated value over the remaining lease term. Instead, any remaining unguaranteed residual asset is reported at its carrying amount at the date of the sale and is subsequently evaluated for impairment using the guidance in ASC 360.

Future lease payments in an operating lease are executory in nature and do not qualify as a recognized financial asset in the balance sheet, unlike lease receivables stemming from sales-type or direct-financing leases discussed above. Accordingly, these lease payments are in the scope of ASC 860 *only* when they are due. A lessor's sale or assignment of future lease payments under an operating lease is accounted for as a secured borrowing under ASC 470 because the lessor's economic interest in an operating lease represents the sale of future revenues in an executory contract rather than a receivable. Therefore, the lessor continues to record lease income on the operating lease in addition to recognizing interest expense on the borrowing. As the lessee makes payments under the lease, the lessor reduces the amount of borrowing based on the portion of the lease payments that represent principal reductions rather than interest expense. Lessors should not offset the lease income and the interest expense on the borrowing (i.e., gross presentation in the income statement is required) since the secured borrowing transaction is separate from the operating lease.

### 6.9.2 Sale and Leaseback Transactions

For guidance on sale and leaseback transactions, refer to Chapter 7.

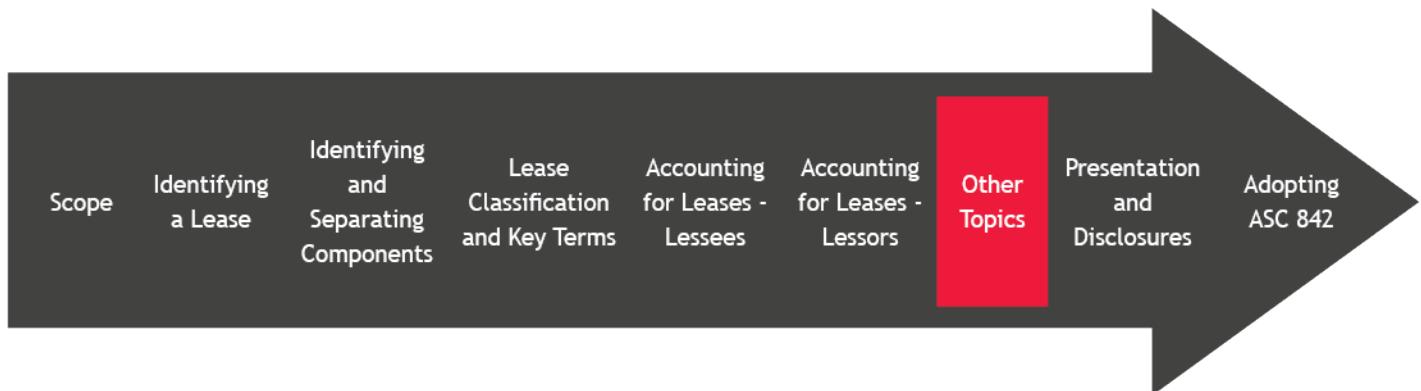
### 6.9.3 Other Transactions

There are other transactions which we have not addressed in this chapter. Those include:

- ▶ Sale of equipment with guaranteed minimum resale amount: see ASC 842-30-55-1 through 55-15,
- ▶ Guarantee payments received: see ASC 842-30-55-16.



# CHAPTER 7 – OTHER TOPICS



## 7.1 OVERVIEW

In Chapters 5 and 6, we discussed the accounting for leases by lessees and lessors, respectively.

In this chapter, we discuss other transactions and topics that are affected by the requirements under ASC 842. Those include:

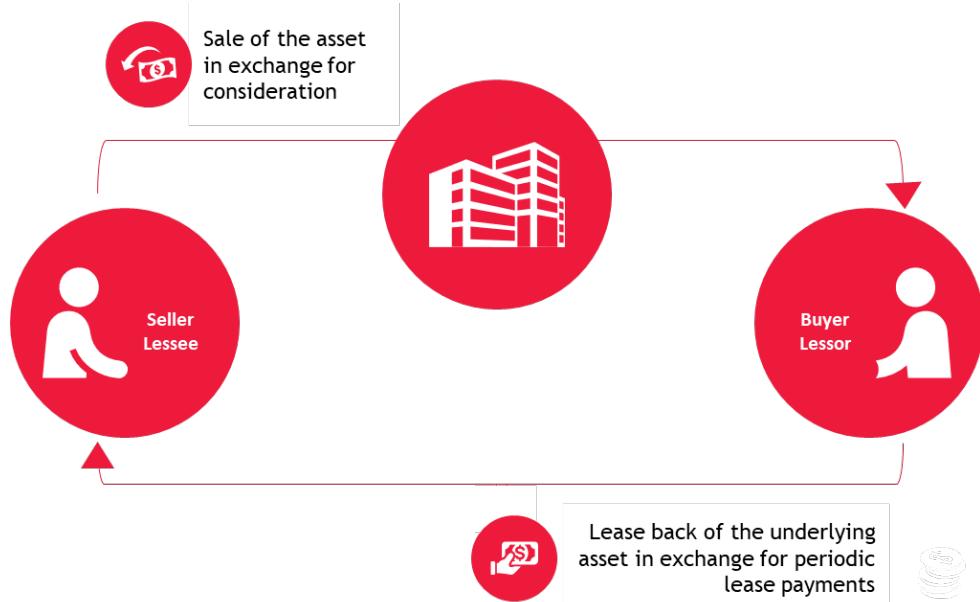
- ▶ Sale and leaseback transactions,
- ▶ Business combinations,
- ▶ Subleases, and
- ▶ Income taxes.



## 7.2 SALE AND LEASEBACK TRANSACTIONS

### 7.2.1 Overview

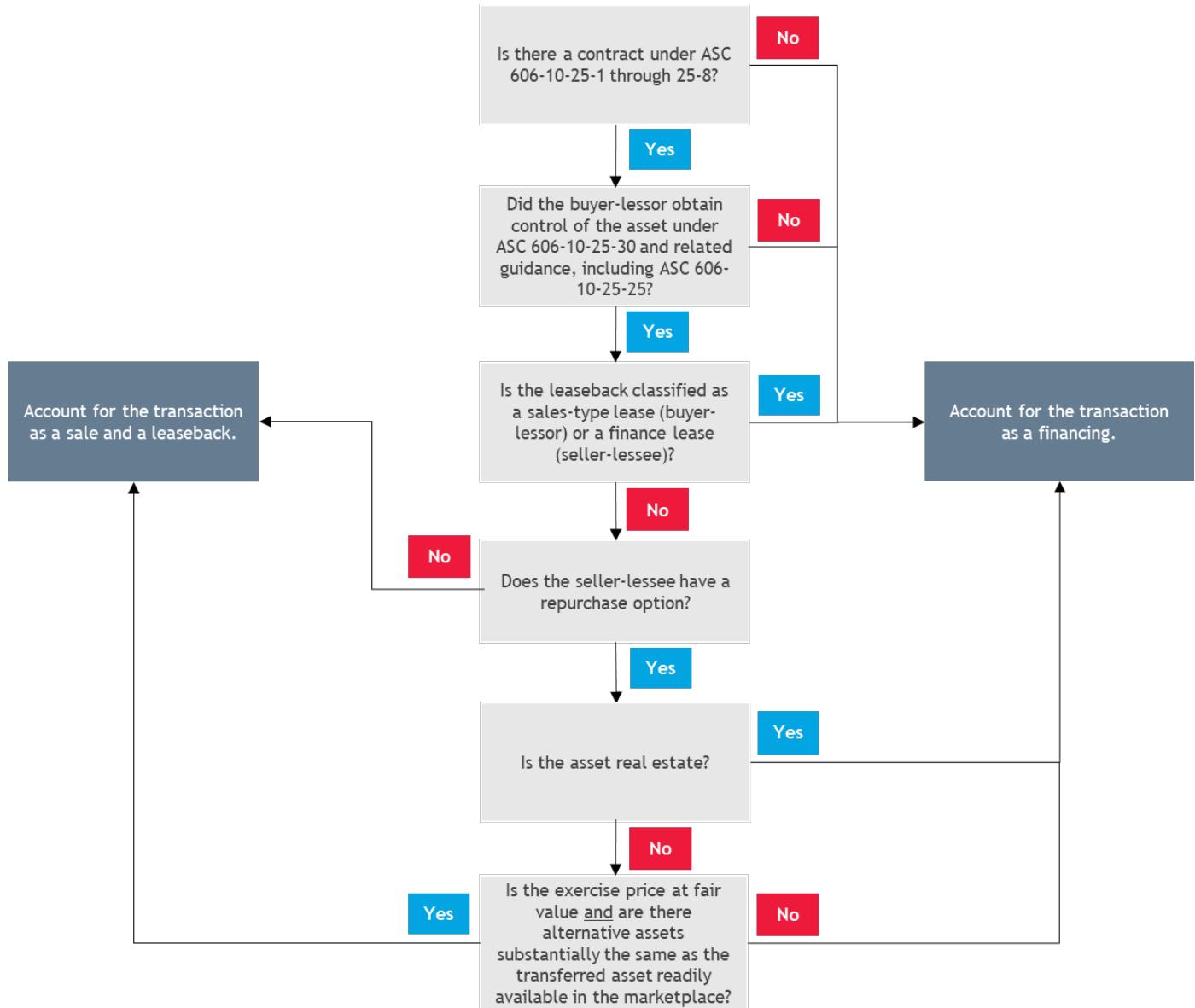
In a sale and leaseback transaction, one entity (seller-lessee) transfers an asset that it owns to another entity (buyer-lessor) and leases that asset back from the buyer-lessor for a period of time in exchange for consideration.



For transactions within the scope of the sale and leaseback guidance, the seller-lessee *and* the buyer-lessor apply the following requirements to determine whether to account for the transaction as a sale and a leaseback, or as a financing arrangement.

|  |  |
|--|--|
| Evaluate under ASC 606 whether a contract exists and whether the buyer-lessor obtains control of the asset                               | ASC 842-40 relies on the guidance in ASC 606 in substantially the same way as does the guidance in ASC 610-20, which applies to sales of nonfinancial assets to parties other than customers. If under ASC 606 a contract does not exist or the buyer-lessor does not obtain control of the asset, no sale has occurred, and the transaction is accounted for as a financing. If a contract exists <i>and</i> the buyer-lessor obtains control of the asset, the entity applies the other requirements below.  |
| Determine whether the leaseback is classified as a sales-type lease (buyer-lessor) or finance lease (seller-lessee)                      | The existence of a leaseback does not by itself prevent the buyer-lessor from obtaining control of the asset. However, if the leaseback is classified as a finance lease by the seller-lessee or a sales-type lease by the buyer-lessor, the buyer-lessor does not obtain control of the asset and the transaction is a financing. This is because the seller-lessee directs the use of, and obtains substantially all of the remaining benefits from, the underlying asset before and after the transaction.  |
| Identify whether the seller-lessee has a repurchase option, and if so, evaluate whether such repurchase option precludes sale accounting | ASC 606 notes that a customer does not obtain control of an asset if the seller has the obligation or the right to repurchase the asset. However, for sale and leaseback transactions, a seller-lessee repurchase option does not preclude sale accounting if: <ul style="list-style-type: none"> <li>► The exercise price is the asset's fair value at the time of exercise, <i>and</i></li> <li>► There are alternative assets, substantially the same as the transferred asset, readily available in the marketplace (in other words, the buyer-lessor could use the proceeds from the repurchase to acquire an asset that is substantially the same in the marketplace).</li> </ul> If either of those two conditions is not met or the transferred asset is real estate (because it is considered unique), the transaction is accounted for as a financing. |

The following flowchart summarizes the decision steps to evaluate the accounting for sale and leaseback transactions:



We will analyze and explain the above steps in further details in the following sections.

### 7.2.2 Scope Considerations

Properly identifying transactions that must be evaluated under the sale and leaseback guidance is a critical step as it may result in accounting for the transaction very differently (for example, the buyer accounting for the transaction as a financing rather than a purchase of the asset). The following section discusses scope considerations.

#### 7.2.2.1 Application By Seller-Lessee and Buyer-Lessor

The guidance in ASC 842-40 applies to both the seller-lessee and the buyer-lessor (that is, it is intended to be symmetrical). This represents a significant change from ASC 840-40, which only applied to seller-lessees. This is also different from ASC 606 which applies to only the seller, not the customer. Buyer-lessors in sale-leaseback transactions must now determine whether they have a ‘successful purchase’ under ASC 842-40. This symmetrical treatment also applies in situations in which the lessee is considered the accounting owner of an asset before lease commencement, as further discussed below.

### 7.2.2.2 Control of Underlying Asset Before Commencement Date

The sale and leaseback guidance applies when the lessee controls the underlying asset before lease commencement. As such, the guidance potentially applies to the following situations depending on the facts and circumstances:

**Lessee obtains legal title to the underlying asset before that title is transferred to the lessor and the asset is leased to the lessee.**



In those situations, the entity assesses whether the lessee *controls* the underlying asset before the asset transfers to the lessor (that is, whether the lessee directs the use of, and obtains substantially all of the remaining benefits from, the asset before it transfers to the lessor).

- ▶ If the lessee controls the asset before the commencement date, the transaction is in the scope of the sale and leaseback guidance.
- ▶ Otherwise, the transaction is accounted as a purchase of the asset by the lessor and a lease between the parties.

This could occur for example in transactions between a manufacturer, a lessor and a lessee for the purchase of an asset by the lessor from the manufacturer, in which the lessee obtains legal title momentarily for tax or other reasons. If the lessee obtains legal title to the asset but does not obtain control of the underlying asset before it is transferred to the lessor, the transaction is not a sale and leaseback transaction.

The evaluation of control should be based on the specific facts and circumstances of the transaction, including whether the lessee obtains physical possession of the asset, has the significant risks and rewards of ownership, and accepts the asset before the asset is transferred to the lessor.

**Entity negotiates a lease before the underlying asset is available for use by the lessee, also referred to as build-to-suit transactions (e.g., the underlying asset must be constructed or redesigned).**



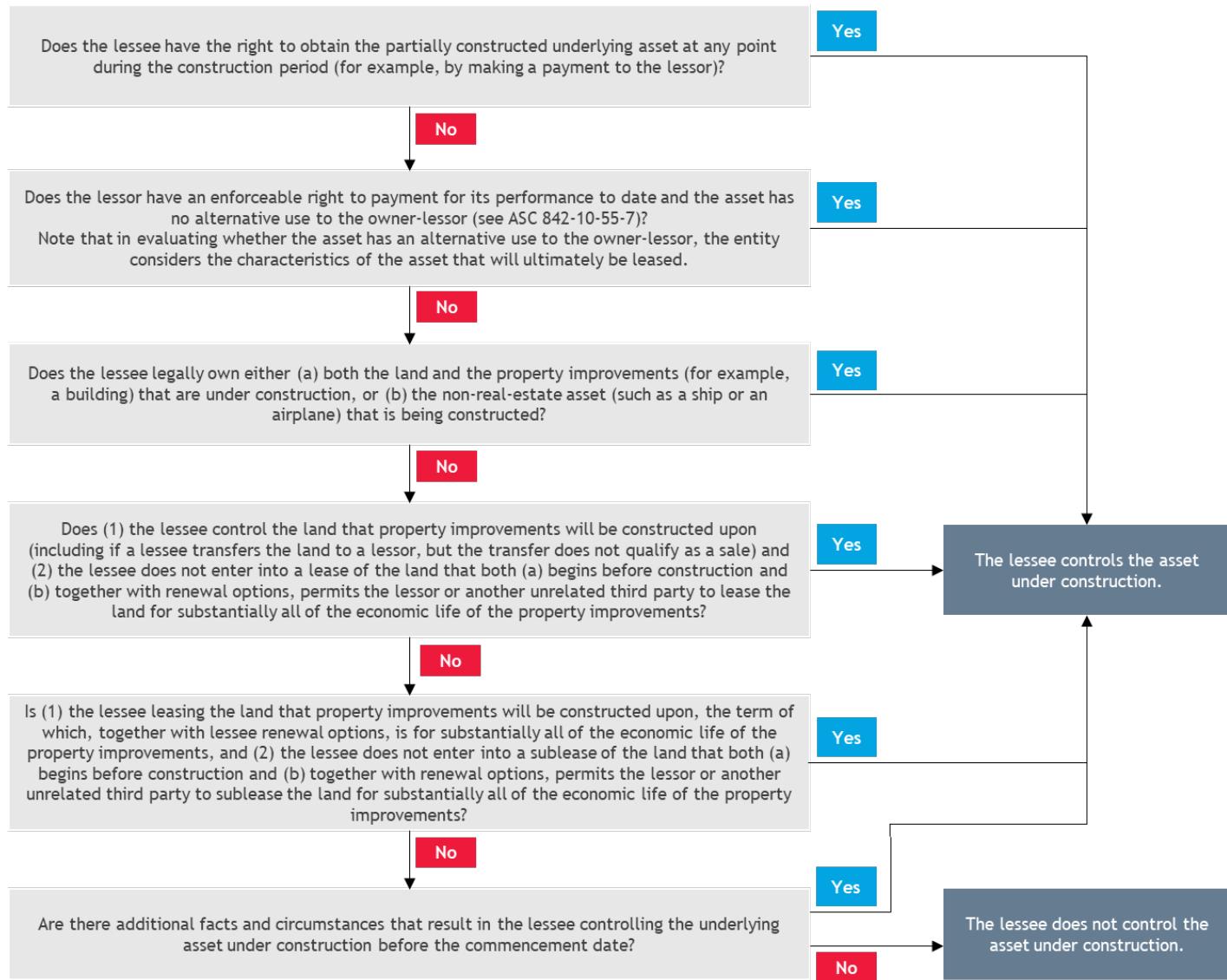
In those situations, the entity assesses whether the lessee controls the underlying asset being constructed before the commencement date by applying the guidance in ASC 842-40-55-5 (discussed on the next page).

If the lessee controls the asset being constructed before lease commencement, the transaction is in the scope of the sale and leaseback guidance.

If the lessee does not control the underlying asset under construction, the lessee may still incur costs relating to the construction or design of the underlying asset before the commencement date (for example, architectural services in developing the building specifications, specific leasehold improvements, etc.). In those situations, the lessee accounts for those costs as follows:

- ▶ Under other GAAP, such as ASC 360 or ASC 330, for lessee-owned assets (for example, leasehold improvements that the lessee pays for during the construction period and that will benefit the lessee in future periods) and for goods or services (other than the lease) provided to the lessee.
- ▶ As lease payments (i.e., prepaid rent), regardless of the timing or form of those payments such as contribution of construction materials, if the payments are made for the right to use the lessor-owned assets.

The following flowchart summarizes the decision steps to determine if the lessee controls the underlying asset under construction:



In the assessment of the first question above, we believe that a purchase option exercisable solely with the passage of time results in the lessee controlling the asset under construction from inception of the arrangement. However, if a purchase option becomes exercisable only after a contingent event, we believe the analysis will require judgment and the conclusion will depend on the specific facts and circumstances of the transaction, including whether the lessee or the lessor controls the occurrence of the contingent event. Also, if the lessor has a put option, we believe the analysis should be consistent with the guidance under ASC 606 (that is, whether the lessor has a significant economic incentive to put the asset back to the lessee).

Because the list of circumstances discussed in ASC 842-40-55-5 is not all inclusive, there could be other circumstances that result in the lessee controlling the underlying asset under construction before the commencement date. Therefore, in evaluating the last question of the flowchart above, judgment will be required to identify such circumstances, if any. In concept, the FASB noted that the evaluation above is similar to the evaluation under ASC 606-10-25-27 when determining if a performance obligation is satisfied over time.

See ASC 842-40-55 Example 3 for an illustration of the application of the above guidance by both the seller-lessee and the buyer-lessor.

If the lessee controls the asset under construction, it should recognize that asset just as it would recognize any other asset it controls, along with a liability for any amounts funded by the lessor. The lessor recognizes a receivable rather than construction in progress. Also, both entities should apply the guidance in Section “Determining whether the transfer of the asset is a sale” to determine if and when to recognize a sale. As discussed in that section, an entity typically cannot conclude that there is a sale until the commencement date of the leaseback.

#### EXAMPLE 1A - LESSEE IS THE ACCOUNTING OWNER DURING ASSET CONSTRUCTION

##### FACTS

- ▶ Rx Hospital owns vacant land adjacent to its hospital. It plans to use the land to expand its operations to include additional medical facilities that will complement its current services provided to patients.
- ▶ Rx Hospital leases the vacant land to MJ Developer before construction begins and for a 40-year term with two 5-year extension options. The completed building is expected to have an economic life of 40 years.
- ▶ Rx Hospital will lease the completed building for an initial 20-year term with two 10-year extension options.
- ▶ Rx Hospital has a purchase option on the asset exercisable at any time throughout the construction period.

##### ANALYSIS

- ▶ RX Hospital entered into a lease of the land before construction begins and for a term including renewals that permit MJ Developer to lease the land for substantially all the property improvements' economic life. However, Rx Hospital has a purchase option exercisable at any time during construction. It is therefore the accounting owner during construction, and the transaction is in the scope of sale and leaseback guidance.
- ▶ Rx Hospital recognizes the construction in progress in accordance with ASC 360. Any amounts funded by MJ Developer are recognized as a financial liability.
- ▶ Because the accounting is symmetrical under ASC 842-40, MJ Developer recognizes a receivable for construction costs incurred (rather than construction in progress) during the construction period.
- ▶ At the end of the construction period (commencement date of the lease), Rx Hospital and MJ Developer will assess whether the transaction qualifies as a sale and a leaseback.

#### EXAMPLE 1B - LESSEE IS NOT THE ACCOUNTING OWNER DURING ASSET CONSTRUCTION

##### FACTS

- ▶ Assume the same facts as in Example 1A, except that Rx Hospital does not have a purchase option. There are no other circumstances resulting in Rx Hospital being the accounting owner of the asset being constructed.
- ▶ Rx Hospital provides various materials during construction of the additional building.

##### ANALYSIS

- ▶ The transaction is not in the scope of the sale and leaseback guidance because Rx Hospital is not the accounting owner of the asset being constructed under ASC 842-40-55-5.
- ▶ Rx Hospital should account for the various materials provided during construction based on their nature. If the costs relate to leasehold improvements, Rx Hospital accounts for those under ASC 360. If the costs do not relate to leasehold improvements or other goods or services (other than the lease) provided to Rx Hospital, but rather are payments for the right to use the building once constructed, Rx Hospital accounts for those as lease payments (i.e., prepaid lease payments).

**EXAMPLE 2 - LESSOR PARTIALLY CONSTRUCTED THE ASSET BEFORE LEASE INCEPTION****FACTS**

- ▶ Lessee is in the luxury cruise line industry, and it enters into a lease with Developer for a new cruise ship that Developer partially constructed at lease inception. The fair value of the partially constructed ship at lease inception is \$25 million, and total expected costs to complete it are approximately \$600 million.
- ▶ Lessee has an option to purchase the partially constructed asset at any point during construction.

**ANALYSIS**

- ▶ Because of the purchase option, Lessee controls the luxury cruise ship under construction and the transaction is in the scope of the sale and leaseback guidance. Lessee therefore recognizes construction in progress at its fair value and a financing obligation at lease inception.
- ▶ Because the accounting is symmetrical under ASC 842-40, Developer derecognizes the construction in progress and recognizes a receivable. The amount of the receivable recognized, along with any selling profit, depends on the facts and circumstances. For example, if Developer has an obligation to complete the construction of the cruise ship, we believe Developer should recognize a receivable at cost plus an appropriate margin based on the percentage of completion method.

**7.2.2.3 Sale of Partially Constructed Asset With Contemporaneous Lease Upon Construction Completion**

In some transactions, the owner of a partially constructed asset may sell the asset “as-is” to a developer (lessor) who commits to complete construction of the asset and to lease the completed asset back to the seller at the end of the construction period. The asset sold may be in different stages of construction (for example, only soft costs incurred, hard costs incurred in varying degrees, and so forth). These transactions are not specifically addressed in ASC 842, and therefore there may be multiple approaches to determine whether such transactions are in the scope of the sale and leaseback guidance. For example, the following approaches may be acceptable if applied consistently by an entity as an accounting policy:

- ▶ All sales of construction-in-progress assets, irrespective of the dollar amounts incurred or the stage of construction, with a commitment to lease the asset back once construction is completed are in the scope of the sale and leaseback guidance.
- ▶ Only transactions for which the construction-in-progress asset is substantially similar to the completed asset are in the scope of the sale and leaseback guidance.

However, because ASC 842 is not clear, other approaches between the two approaches described above may also be acceptable, such as establishing a threshold at which construction-in-progress assets with a commitment to lease the asset back once construction is completed are in the scope of the sale and leaseback guidance.

**EXAMPLE 3A - SALE OF A PARTIALLY CONSTRUCTED ASSET****FACTS**

- ▶ Lessee is in the logistics industry and has started construction of a new plane that it owns. So far it has incurred \$75,000 in construction costs and total costs are expected to be approximately \$350,000.
- ▶ Lessee sells the partially constructed plane to Aircraft Builder who agrees to complete construction of the plane and to lease the completed plane back to Lessee at the end of the construction period.
- ▶ Lessee is not the accounting owner of the asset during the remainder of the construction period (i.e., none of the conditions in ASC 842-40-55-5 are met after lease inception).

**ANALYSIS**

- ▶ Lessee has made an accounting policy to account for such transactions under the sale and leaseback guidance only if the partially constructed asset is substantially similar to the completed asset.
- ▶ Lessee considers the facts and circumstances of the transaction, including costs incurred to date compared to total expected costs, and concludes that the transaction is not in the scope of the sale and leaseback guidance because the partially constructed asset is not substantially similar to the completed asset.
- ▶ Lessee applies other GAAP (e.g., ASC 610-20) to determine whether and when to recognize the sale.

**EXAMPLE 3B - SALE OF A PARTIALLY CONSTRUCTED ASSET WITH A REPURCHASE OPTION****FACTS**

- ▶ Assume the same facts as above, except that the sale contract with Aircraft Builder provides Lessee with an option to purchase the partially constructed plane at any time during the construction period.

**ANALYSIS**

- ▶ The purchase option results in Lessee being the accounting owner of the asset under construction in accordance with ASC 842-40-55-5(a). Therefore, Lessee does not derecognize the partially constructed plane and accounts for the proceeds from the sale as a financial liability. Lessee will recognize any additional amounts funded by Aircraft Builder for the construction of the plane as increases to value of the construction in progress asset and the financial liability.
- ▶ Because sale-leaseback accounting is symmetrical, Aircraft Builder accounts for the cash paid and any additional amounts funded for the construction of the plane as a receivable rather than construction in progress.
- ▶ Lessee and Airplane Builder should wait until the commencement date of the leaseback to determine whether sale and leaseback is achieved. This is because ASC 842-40 precludes sale accounting when the leaseback is classified as a finance lease by the seller-lessee or sales-type lease by the buyer-lessor, and classification of the leaseback cannot be assessed prior to the commencement date.

#### 7.2.2.4 Sale or Transfer of Purchase Option to Third-Party With Leaseback of Asset

An entity may sell or transfer a purchase option on an asset to a third-party with a commitment from the third-party to exercise the option and lease the asset back to the entity. For example, a lessee may have a purchase option under an existing lease of a building (or equipment) which the lessee assigns to a third-party. In turn, the third-party commits to exercise the option to purchase the building (or equipment) and to lease the asset back to the lessee once the asset is purchased. Terms and conditions in such transactions may vary, such as the price at which the purchase option is exercisable (fair value vs. fixed price), whether the purchase option is currently exercisable, and so forth. Care should be given in these situations based on the specific facts and circumstances of the transaction to determine whether the sale and leaseback guidance applies. However, consistent with the concepts underlying the guidance in ASC 842-40-25-3 on repurchase options, we believe that if there are alternative assets substantially the same as the asset subject to the transaction and the strike price is fair value, the transaction may not be within the scope of the sale and leaseback guidance. This is because the lessee could have negotiated with a third-party (e.g., bank) for the direct purchase and lease of a different (but substantially similar) asset, which would not be subject to the sale and leaseback guidance. However, for assets like real estate, we believe such transactions will be in the scope of the sale and leaseback guidance because no two real estate assets are the same.

#### EXAMPLE 4 - ASSIGNMENT AND EXERCISE OF A PURCHASE OPTION IN A REAL ESTATE LEASE

##### FACTS

- ▶ Distributor is the lessee of a warehouse that has a noncancelable term of ten years and for which the expiration is approaching. The lease includes two fixed price extension options for ten years each, and a fair market value purchase option exercisable at the end of the initial ten-year term.
- ▶ Distributor assigns the purchase option to Real Estate Co which commits to exercise the purchase option and to purchase the warehouse subject to due diligence procedures. Upon closing, Real Estate Co agrees to lease the warehouse to Distributor for a noncancelable period of ten years. The lease includes two fixed price extension options and a fair value purchase option.
- ▶ Following the due diligence procedures being satisfactory to Real Estate Co, the transaction closes and the lease between Distributor and Real Estate Co commences.

##### ANALYSIS

- ▶ In this example, Distributor and Real Estate Co evaluate the transaction and determine, based on the facts and circumstances of the transaction (including that the purchase option is on a real estate asset, which is considered unique) that Distributor is considered to control the warehouse before Real Estate Co's purchase, even though Distributor does not legally own the warehouse. Therefore, the transaction is in the scope of the sale and leaseback guidance.
- ▶ Because the lease between Distributor and Real Estate Co also includes a purchase option, the transaction is accounted for as a financing by Distributor and Real Estate Co.

#### 7.2.2.5 Sale-Leaseback Transactions - Consolidation of Buyer-Lessors

Certain sale-leaseback transactions may be structured with a legal entity that the buyer-lessor specifically created for tax, legal or other reasons to hold assets related to one or more sale and leaseback transactions. In those situations, a seller-lessee should carefully consider whether it has a controlling financial interest in the buyer-lessor under ASC 810, under the variable interest entity (VIE) model or the voting model. If the lease is a finance lease or includes a repurchase option, residual value guarantee or another feature that is a variable interest in the buyer-lessor entity, the VIE subsections of ASC 810 would apply unless a scope exception is met. If the VIE subsections apply, the seller-lessee should determine whether the buyer-lessor is a VIE and if so, whether it is the primary beneficiary and has a controlling financial interest in the buyer-lessor entity. If the buyer-lessor is not a VIE, the seller-lessee determines whether it has a controlling financial interest under the voting model. If the seller-lessee has a controlling financial interest in the buyer-lessor entity, the seller-lessee would apply ASC 810 and consolidate the buyer-lessor entity.

For further discussion on the application of the VIE guidance in ASC 810, see our publication [BDO Knows: Variable Interest Entities](#) available [here](#). See also this [link](#) for a consultation the SEC staff discussed at the 2019 AICPA Conference on Current SEC and PCAOB Developments related to a sale-leaseback transaction involving a variable interest entity. Because transactions may be structured in a variety of ways, reaching a conclusion requires the application of professional judgment based on facts and circumstances.

#### 7.2.2.6 Lessee Indemnity for Preexisting Environmental Contamination

A lessee may be required to indemnify the lessor for preexisting environmental contamination. However, this provision alone does not mean that the lessee controlled the underlying asset prior to the lease commencing. This is regardless of the likelihood of a loss resulting from the indemnity. Therefore, the presence of such a provision does not mean the transaction is in the scope of the sale and leaseback guidance.

#### 7.2.2.7 Sale-Leaseback-Sublease Transactions

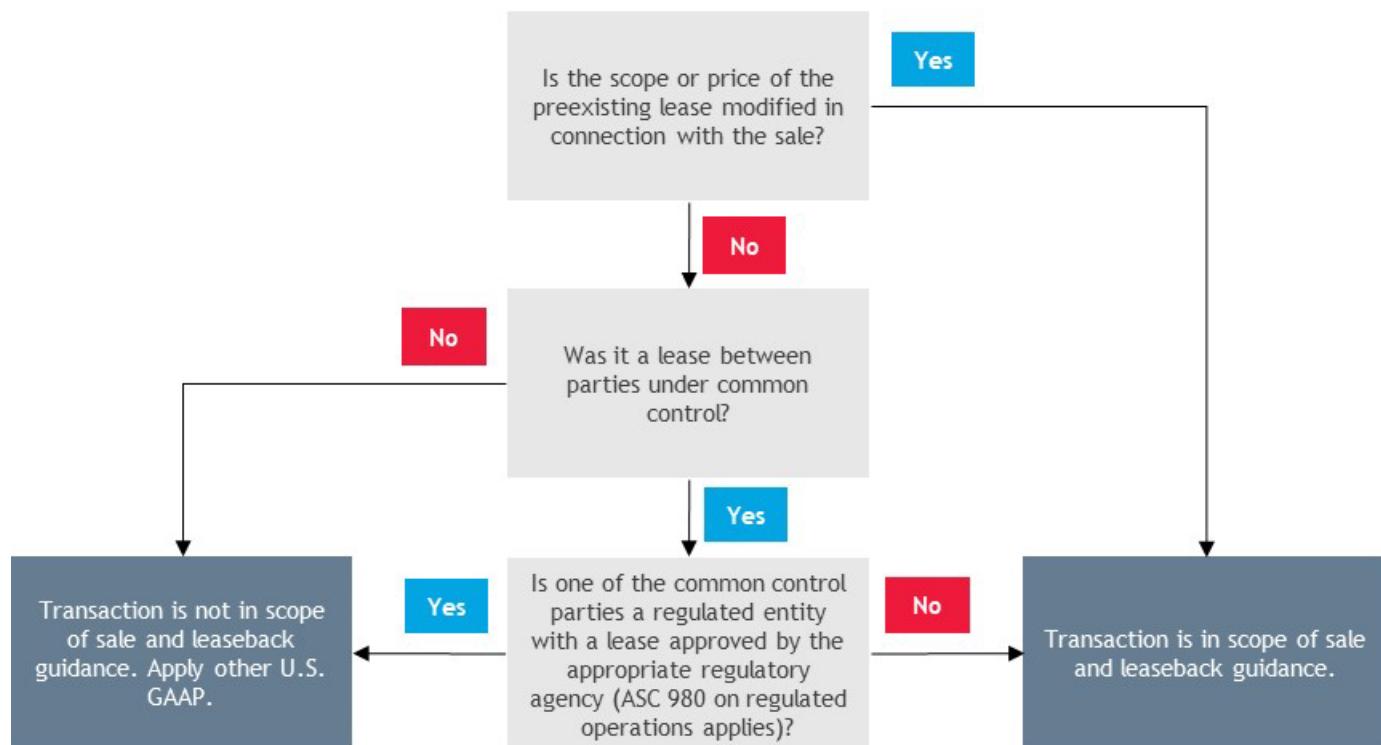
An entity may enter into a sale-leaseback transaction for which the asset is subject to an operating lease or is subleased (or intended to be subleased) by the seller-lessee to another party under an operating lease. A sale-leaseback-sublease transaction is within the scope of the sale and leaseback guidance. However, the existence of the operating sublease does not by itself prevent the buyer-lessor from obtaining control of the asset nor does it prevent the seller-lessee from controlling the asset before the transfer. All facts and circumstances should be considered in determining whether the buyer-lessor obtains control of the underlying asset in a sale-leaseback-sublease transaction.

#### 7.2.2.8 Sale Subject to a Preexisting Lease

An entity or a person may obtain an ownership interest in an underlying asset and at or near the same time enter into an operating lease as a lessee for all or a portion of the underlying asset. For example, a medical office practice or a physician might obtain an ownership interest in a partnership or similar entity that owns a medical office building and at or near the same time enter into a lease for all or a portion of the medical office building.

If the lessee (the medical office practice or physician) subsequently sells its interest in the partnership, or the partnership sells the underlying asset to an unrelated third party (buyer-lessor), and the lessee continues to lease the underlying asset, the reporting entity should first determine whether the transaction is in the scope of the sale and leaseback guidance.

ASC 842-40-55-9 and 55-10 provide additional details to determine whether the guidance is applicable as illustrated in the following flowchart:



As depicted above, when the answer to the first question in the flowchart is ‘No’ because the scope or price of the lease is not modified as part of the transaction, whether the transaction is in the scope of the sale and leaseback guidance depends on whether the in-place lease between the lessee and original owner/lessor was considered a common control lease. A lease between parties under common control is not considered a preexisting lease, and therefore the transaction would be in the scope of the sale and leaseback guidance (except for entities in the scope of ASC 980).



#### BUYER-LESSOR CONSIDERATIONS FOR SALES SUBJECT TO PREEXISTING LEASE

Previously, this guidance applied only to seller-lessees under ASC 840, who were expected to have the necessary information to evaluate whether common control existed. However, the sale and leaseback guidance under ASC 842 now applies to **both** seller-lessees and buyer-lessors.

It may be challenging for the buyer-lessor to determine whether the original lessor and lessee were under common control if it does not have the necessary information. Therefore, it may be helpful for the buyer-lessor to request relevant information to making this determination as part of the negotiations.

**BDO INSIGHTS – DEFINING “COMMON CONTROL”**

Although the term “common control” is not defined in U.S. GAAP, practice has generally interpreted it to include relationships in which a controlling financial interest exists under the voting model or the VIE model (unless a scope exception applies) and includes other fact patterns observed by the SEC Staff in EITF Abstract *Definition of ‘Common Control’ in Relation to FASB Statement No. 141*. We believe an entity must apply the term “common control” consistently in its financial statements (for example, when applying ASC 810 and evaluating sale and lease back transactions).

Reaching a conclusion as to whether an arrangement is a common control lease requires the application of professional judgment based on facts and circumstances.

**7.2.2.9 Modification of a Finance Lease to an Operating Lease**

An entity may modify a finance lease such that the modified lease is classified as an operating lease. ASC 840-40-15-6 required a lessee to apply sale-leaseback guidance to modifications of a capital lease giving rise to a new agreement classified as an operating lease. The lease modification guidance under ASC 842 does not have similar requirements and, in fact, ASC 842-10-25-14 provides guidance for modifications of a finance lease to an operating lease and requires certain adjustments to account for the lease prospectively. Therefore, we believe that a modification of a finance lease to an operating lease under ASC 842 is not within the scope of the sale-leaseback guidance.

**7.2.2.10 Transfer of Tax Benefits**

Refer to ASC 842-40-55-11 through 55-17 for additional guidance.

### 7.2.3 Determining Whether the Transfer of the Asset Is a Sale

If a transaction is in the scope of the sale and leaseback guidance, the entity (seller-lessee and buyer-lessor) must determine whether the transfer of the asset is a sale. To do so, the entity:

- ▶ Evaluates under ASC 606:
  - Whether a contract exists, and
  - Whether the buyer-lessor obtains control of the asset,
- ▶ Assesses classification of the leaseback to determine whether the leaseback is classified as a finance lease (seller-lessee) or sales-type lease (buyer-lessor), and
- ▶ Identifies repurchase options and determines if such repurchase options preclude sale accounting.

#### BDO INSIGHTS – LEVEL OF ANALYSIS FOR SALE ASSESSMENT

In some sale and leaseback transactions, a seller-lessee may sell an entire asset and enter into a leaseback of only a physically distinct portion of that asset based on its business needs. For example, a seller-lessee may sell a multi-story office building in which it leases back one or more but not all the floors in the building. In other transactions, a seller-lessee may sell and lease back land and improvements, such as an office building or a warehouse. In those situations, a question arises as to what level the sale analysis should be performed.

We believe the transfer of control (or sale) assessment under ASC 606 is typically performed at the legal title level, such as a legally titled piece of equipment or real estate property. For example, in the multi-story sale-leaseback transaction described above, the analysis under ASC 606 will depend on whether the distinct portion leased back (the floor) is legally distinct (that is, whether the building is legally subdivided or condominiumized).

- ▶ If it is, the analysis under ASC 606 will be performed for the legally distinct portion (floor) that is being leased back. The other legally distinct portions of the asset (the other floors not leased back by the seller-lessee) are not in the scope of the sale and leaseback guidance and will be assessed under other GAAP, such as ASC 610-20 for the seller and ASC 360 for the buyer.
- ▶ If the portion leased back is not legally distinct, the analysis under ASC 606 will typically be performed at the level at which legal title resides, which is usually the building itself.

However, there is an alternative view as it relates to land. For transactions where a seller-lessee sells real estate comprising a single titled land and building to a buyer-lessor, and then leases the property back from the buyer-lessor (which leaseback includes the leaseback of the building and an explicit or implicit leaseback of the land), we understand that there are two views applied in practice:

- ▶ The analysis under ASC 606 is performed at the legal title level consistent with the guidance discussed above, which results in the single titled land and building being assessed under ASC 606 as one unit.
- ▶ The land and building are treated as separate units of account under ASC 606 because land (1) by nature, is unique, (2) is accounted for as a separate asset under ASC 360 and (3) is typically considered a separate lease component under ASC 842-10-15-29.

For sale-leaseback transactions involving a single titled land and building discussed above, an entity should select its accounting policy and apply it consistently to similar transactions.

See also Section 7.2.3.3 for further discussion on leaseback classification and impact on sale assessment.

### 7.2.3.1 Is There a Contract?

In accordance with ASC 606-10-25-1, all of the following conditions must be met for a contract to exist:



The parties to the contract have approved the contract and are committed to perform their respective obligations. The contract may be in writing, orally, or in accordance with other customer business practices.



The entity can identify each party's rights regarding the goods or services to be transferred. That is, the legal rights regarding the transfer of the goods/ property are identifiable for the seller-lessee and the buyer-lessor.



The entity can identify the payment terms for the goods or services to be transferred.



The contract has commercial substance. In other words, the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract.



It is probable the entity (the seller-lessee) will collect substantially all the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer (the buyer-lessor).

The application of this step generally does not create application issues. This is because sale and leaseback transactions typically include at least a purchase and sale agreement and a lease agreement, for which the rights and obligations of each party are clearly identified, including payment terms. Also, in many sale-leaseback transactions, the transaction has economic substance because the buyer-lessor pays the consideration upfront and takes on risks associated with the asset, including risks of changes in fair market rent, changes in the fair value of the asset, credit risk and so forth.

Once the entity concludes that a contract exists, the next step is to determine whether the buyer-lessor has obtained control of the asset.

### 7.2.3.2 Does the Buyer-Lessor Obtain Control of the Asset?

The following control indicators in ASC 606-10-25-30 are used to evaluate whether the buyer-lessor has obtained control of the asset:



The seller-lessee has a present right to payment for the asset.



The buyer-lessor has legal title to the asset.



The seller-lessee has transferred physical possession of the asset. However, in sale and leaseback transactions, the buyer-lessor generally does not receive physical possession of the asset until the end of the lease and therefore this indicator will typically not be present.



The buyer-lessor has the significant risks and rewards of ownership; for example, when the buyer-lessor has the ability to sell the asset if the property value increases and also absorbs any losses if the property value declines.



The buyer-lessor has accepted the asset. However, this indicator may not be applicable in sale and leaseback transactions that do not include agreed-upon specifications for the asset.

The assessment of most indicators above will be objective in nature (for example, the seller-lessee's present right to payment or the buyer-lessor having legal title). But the analysis of the risks and rewards indicator may be subjective and there may be limitations on risks that the buyer-lessor takes. For example, a seller-lessee may guarantee the residual value of the asset at the end of the lease term. Such guarantee does not in isolation preclude accounting for the transaction as a sale and leaseback. Instead, the guarantee is considered in the entity's overall consideration of the risks and rewards indicator. The analysis may therefore require the use of professional judgment and the entity should consider in its overall assessment the principle of transfer of control in ASC 606-10-25-25, which is that the customer (in this case, the buyer-lessor) has the right to direct the use of, and obtain substantially all of the remaining economic benefits from, the asset. The lessee residual value guarantee should also be included in the determination of lease classification discussed below.

### 7.2.3.3 Is the Leaseback a Finance Lease or Sales-Type Lease?

The existence of the leaseback does not by itself prevent the buyer-lessor from obtaining control of the asset. Because the lease payments received by the buyer-lessor during the lease term, plus the benefits that the buyer-lessor can generate from the residual asset after the lease term, represent substantially all of the remaining benefits to be derived from the asset immediately before the asset is leased to the seller-lessee, the buyer-lessor obtains control of the asset.

However, when a lease is classified as a finance lease by the seller-lessee or a sales-type lease by the buyer-lessor, the seller-lessee controls the underlying asset as a result of the leaseback; that is, the seller-lessee directs the use of, and obtains substantially all the remaining benefits from, the underlying asset. The FASB determined that no sale should occur because a finance lease is economically similar to purchasing the asset, and it would be inappropriate for a seller-lessee to account for a concurrent sale and, in effect, repurchase of the same asset. In an operating lease, the seller-lessee does not obtain substantially all of the remaining benefits from the underlying asset, and thus an operating leaseback does not preclude accounting for the transaction as a sale.

In performing this step, an entity assesses classification at the leaseback commencement date and at the lease component level. Accordingly, if there are multiple assets, the lease components must be identified first. See Chapter 3 for additional details on identifying the components of a contract.

| EXAMPLE LEASE COMPONENTS  |   |
|---|---|
|   | Right to use real estate, such as a retail store in a mall, or a floor in an office building. |
|  | Right to use computer equipment.  |
|  | Right to use a vehicle, such as a truck.  |



#### CAREFULLY EVALUATE THE ACCOUNTING WHEN LEASEBACK HAS NOT YET COMMENCED

In some sale and leaseback transactions, the leaseback does not commence until a future period (for example, until a building or warehouse is constructed or renovated). In those situations, the entity cannot recognize a sale (or purchase) until the leaseback commences. This is because ASC 842-40-25-2 requires an assessment of the classification of the leaseback, which is done at lease commencement. Therefore, even if there is a high likelihood that the lease will be classified as an operating lease by the seller-lessee, or a direct financing or operating lease by the buyer-lessor, an entity cannot determine that a sale exists until the leaseback commences.

**EXAMPLE 5 - SALE OF LAND WITH LEASEBACK FOLLOWING CONSTRUCTION OF A BUILDING****FACTS**

- ▶ Rx Hospital owns vacant land adjacent to its hospital and it plans to expand its operations to include additional medical facilities that complement its current services provided to patients.
- ▶ To that effect, Rx Hospital sells the vacant land to MJ Developer who will construct the building.
- ▶ Once construction is completed, Rx Hospital agrees to lease the completed building for a noncancelable term of 20 years, with two 10-year extension options.

**ANALYSIS**

- ▶ The leaseback of the medical office building once construction is completed includes an implicit lease of land (see Chapter 2 on definition of a lease). Therefore, the sale of the land is in the scope of the sale and leaseback guidance.
- ▶ Rx Hospital and MJ Developer cannot conclude that a sale has occurred until leaseback commencement. Therefore, Rx Hospital (not MJ Developer) recognizes the land during the construction period.
- ▶ Both entities should also determine whether Rx Hospital is the accounting owner of the building under construction (See Section 7.2.2.2 for additional discussion).

**BDO INSIGHTS – FINANCE (SALES-TYPE) LEASEBACK CLASSIFICATION FOR DISTINCT PORTION OF ASSET SOLD**

As discussed above, if the leaseback is determined to be a finance lease by a seller-lessee or a sales-type lease by a buyer-lessor, the transaction is accounted for as a financing. This aspect of the guidance is clear and generally straight forward. However, in some sale and leaseback transactions, a seller-lessee may not need to lease back the entire asset sold and therefore may lease back only a distinct portion of it. For example, a seller-lessee may sell a multi-story office building and lease back one or more but not all floors. In those situations, the accounting for the transaction will depend on the unit of evaluation, specifically, whether the portion leased back (the floor) is legally distinct (that is, whether the building is legally subdivided). See earlier discussions in Section 7.2.3 for further details.

- ▶ If the portion of the asset (floor) subject to the leaseback is legally distinct, the analysis under ASC 842-40 is performed for the legally distinct portion. Therefore, if the leaseback of that distinct portion is a finance lease to the seller-lessee or a sales-type lease to the buyer-lessor, this will preclude sale accounting for that portion being leased back. The other legally distinct portions of the asset (the other legally distinct floors not leased back by the seller-lessee) are not in the scope of the sale and leaseback guidance and will be assessed under other U.S. GAAP, such as ASC 610-20 for the seller and ASC 360 for the buyer.
- ▶ If the portion leased back (floor) is not legally distinct (for example, legal title is for the entire building), then the analysis will depend on the significance of the leaseback to the transaction. Consistent with the principle of transfer of control in ASC 606-10-25-25, which requires that the customer (in this case the buyer-lessor) obtains substantially all of the remaining economic benefits from the underlying asset, we believe that sale accounting will be precluded unless (a) the leaseback is for a minor portion of the asset sold and (b) the other requirements for sale accounting discussed in Sections 7.2.3.1, 7.2.3.2 and 7.2.3.4 are met. The leaseback could be minor, for example, if the leaseback is for one floor of a 20-story office building.

Also, when the portion leased back is not legally distinct and sale accounting is precluded based on the facts and circumstances, additional complexity in the accounting for the transaction as a financing may arise. Specifically, the entity should consider any accounting implications for the portions of the asset that are not leased back by the seller-lessee. For example, a seller-lessee may sell a 5-story office building that is not legally subdivided to a buyer-lessor in which it leases back floors 1 and 2, but not floors 3 to 5 of the building, and the leasebacks of floors 1 and/or 2 are finance (sales-type) leasebacks and considered significant, thereby precluding sale accounting. In that scenario, the entity should consider how to account for floors 3 to 5 that the seller-lessee does not lease back. We understand that there is diversity in practice in those situations with some entities:

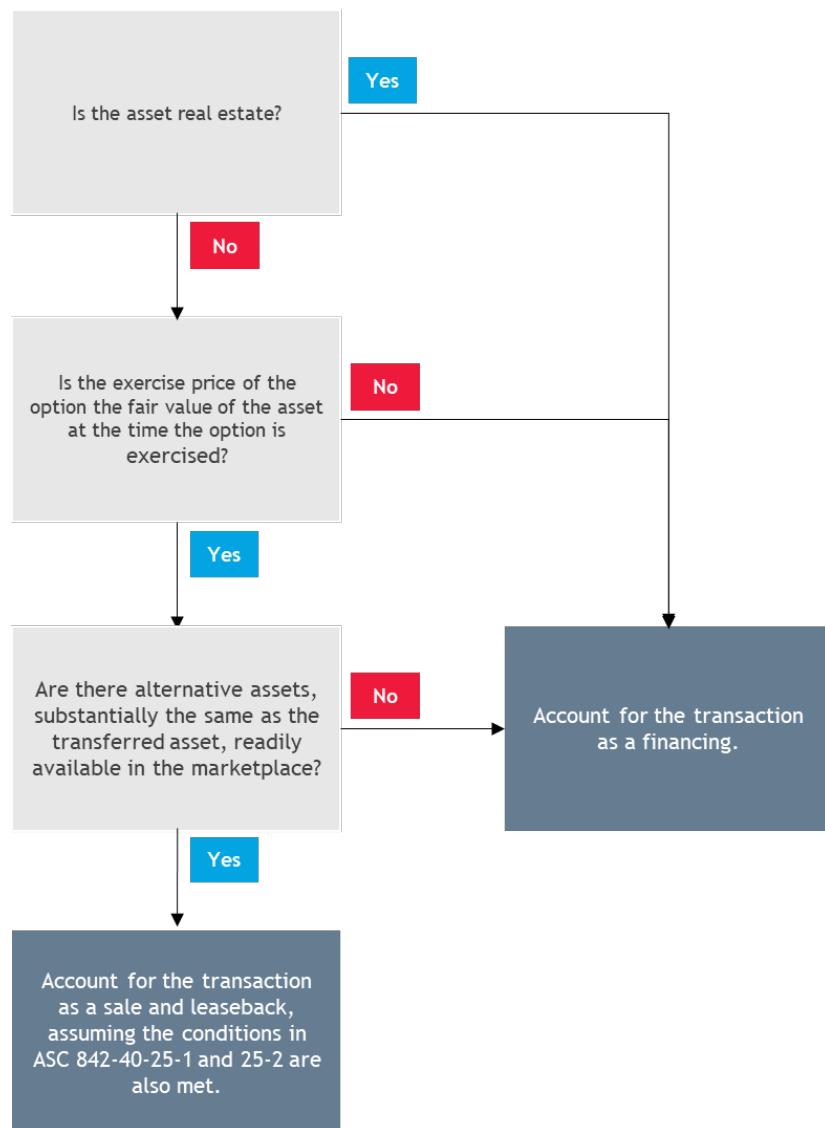
- ▶ Concluding that the entire transaction is a financing transaction. Under this framework, the seller-lessee recognizes the full amount of consideration received as a financing liability. In subsequent accounting for the transaction, the seller-lessee allocates rents paid to the buyer-lessor for the floors being leased back between interest expense and reduction of the financing liability. The seller-lessee also imputes lease income on the floors that are not leased back (for example, floors 3 to 5, which are considered leased out since the seller-lessee remains the accounting owner of the entire building), with a portion recognized as interest expense and the remainder as a reduction of the financing liability. This accounting is consistent with guidance that existed in ASC 840-20-35-4.
- ▶ Continuing the assessment further for the components that are not leased back by the seller-lessee (for example, floors 3 to 5, which are deemed to be leased to the buyer-lessor by the seller-lessee as accounting owner/lessor of the asset). This may result in classifying those components as sales-type leases or finance leases, for example if title of the asset transfers by the end of the lease term, or the proceeds from the purchase price allocated to the distinct portion represents substantially all of the fair value of the distinct asset.

#### 7.2.3.4 Is There a Repurchase Option?

Under ASC 606, a customer does not obtain control of an asset if the seller has the obligation or the right to repurchase the asset. However, the FASB decided that certain repurchase options do not preclude sale accounting. The FASB noted in paragraph BC352 of ASU 2016-02 that “a buyer-lessor is not constrained in its ability to direct the use of and obtain substantially all the remaining benefits from the asset if the seller-lessee can only repurchase the asset at its then-prevailing fair market value and the buyer-lessor could use the proceeds from the repurchase to acquire an asset that is substantially the same in the marketplace.”

The FASB also noted in paragraph BC352(c) that “Board members generally observed that real estate assets would not meet criterion (2). This is because real estate is, by nature, ‘unique’ (that is, no two pieces of land occupy the same space on this planet) such that no other similar real estate asset is ‘substantially the same’.” Therefore, a repurchase option in a sale-leaseback transaction involving real estate (including integral equipment as defined in ASC 978) will always preclude sale accounting, even if the repurchase option is at fair value.

The following flowchart summarizes the decision steps under ASC 842 to determine whether an unconditional repurchase option precludes sale and leaseback accounting (see discussion below of contingent repurchase options, rights of first offer and rights of first refusal).



Also, sale and leaseback transactions may include terms, such as extension options for substantially all of the remaining economic life of the asset, or residual value guarantees, that have resulted in practice issues in the application of ASC 842-40-25-3.

#### BDO INSIGHTS – RENEWAL CLAUSES

Some lease arrangements may provide for fixed price or fair value renewal options for all or substantially all of the remaining economic life of the underlying asset. In paragraph BC218 of ASU 2016-02, the Board concluded that “a purchase option is the ultimate option to extend the lease term. A lessee that has an option to extend a lease for all of the remaining economic life of the underlying asset is, economically, in a similar position to a lessee that has an option to purchase the underlying asset. Accordingly, the Board decided that those two options should be accounted for in the same way.”

Accordingly, we believe that care should be given in determining whether renewal options are economically the same as repurchase rights, and whether such renewals preclude sale accounting (e.g., whether the renewal options are at a fixed price versus at fair market rent, the nature of the underlying asset). Entities are encouraged to discuss such transactions with their accounting advisor or auditor.

#### BDO INSIGHTS – RESIDUAL VALUE GUARANTEES IN A SALE-LEASEBACK

In some equipment sale and leaseback transactions, a seller-lessee may guarantee the residual value of the asset and may also have a fair value repurchase option exercisable at the end of the lease term. Accordingly, the amount the buyer-lessor will receive upon exercise of the repurchase option depends on the fair value at the exercise date compared to the residual value guarantee (RVG) amount. If the fair value of the asset is equal to or greater than the RVG, no payment under the RVG is triggered and the buyer-lessor receives an amount equal to fair value. If the fair value of the asset is less than the RVG and the seller-lessee exercises its repurchase right, the buyer-lessor would receive the RVG amount (that is, an amount in excess of fair value). Therefore, the repurchase option is not solely at fair value. However, if all other conditions for sale accounting are met (that is, the conditions in ASC 842-40-25-1 and 25-2 are met), the transaction may still meet the conditions in ASC 842-40-25-3 on repurchase options if there are alternative assets, substantially the same as the equipment, that are readily available in the marketplace. This is because the buyer-lessor will always receive an amount that is at least equal to fair value, which it could use to acquire an equivalent asset at fair value in the marketplace.

Lastly, transactions involving the sale and leaseback of real estate often include various forms of repurchase rights. Those rights may include conditional (or contingent) repurchase rights, rights of first refusal, and rights of first offer. We discuss those below along with considerations as to whether such clauses preclude sale accounting.

#### BDO INSIGHTS – CONTINGENT REPURCHASE OPTIONS IN REAL ESTATE SALE AND LEASEBACK TRANSACTIONS

Lease agreements may include repurchase rights that can only be exercised if a specified event has occurred; for example, if there is a change of control of the buyer-lessor or seller-lessee. ASC 842-40 does not specifically address contingent repurchase options. However, paragraph BC 352(c) in the Basis of Conclusions of ASU 2016-02 makes clear that the guidance on repurchase options is based on the guidance on repurchase rights in ASC 606. Under ASC 606, contingent repurchase options do not automatically preclude sale accounting. Rather, such repurchase options are evaluated based on the specific facts and circumstances of the transaction. For example, if a repurchase option is exercisable based on a contingent event that is within the entity's (seller's) control, this generally implies that the customer has not obtained control of the asset and, therefore, sale accounting is precluded. In contrast, if the contingency is within the customer's control, this may imply that the customer has the ability to determine whether the repurchase option is exercisable and, therefore, the customer is not limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset.

Therefore, similar to contracts with contingent repurchase options within the scope of ASC 606, we believe that for real estate:

- ▶ A sale-leaseback transaction that includes a contingent repurchase option for which the contingency is within the seller-lessee's control would preclude sale-leaseback accounting.
- ▶ A sale-leaseback transaction that includes a contingent repurchase option for which the contingency is within the buyer-lessor's control may not preclude sale-leaseback accounting, even if the underlying asset is real estate. The evaluation would be similar to the evaluation of buyer put rights under ASC 606 (that is, whether the buyer-lessor has a significant economic incentive to exercise the put).
- ▶ If the contingency is outside the control of both the seller-lessee and buyer-lessor, whether sale-leaseback accounting is achieved depends on the specific facts and circumstances of the transaction. For example, if the contingent event was put in place as a protective measure and the likelihood at the transaction date that the event will occur is remote, this may imply that the buyer-lessor has obtained control of the asset, even if the underlying asset is real estate. In contrast, if the contingent event was put in place in contemplation of a transaction or event potentially occurring in the near future and at the transaction date that contingent event is likely to occur, this may imply that the buyer-lessor has not obtained control of the asset because the buyer-lessor is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset (because there is a contingency that is outside of its control and the contingent event is likely to occur).

#### BDO INSIGHTS – RIGHT OF FIRST REFUSAL IN REAL ESTATE SALE AND LEASEBACK TRANSACTIONS

A right of first refusal (ROFR) is most commonly structured as an option that grants the seller-lessee the right to repurchase the property subject to the sale-leaseback transaction if the buyer-lessor obtains a bona fide offer from a third-party to purchase the property. A ROFR will generally only allow the seller-lessee the right to match that third-party offer. If the seller-lessee elects to exercise the ROFR, the buyer-lessor must sell the property to the seller-lessee, rather than to the third-party.

A provision that allows the seller-lessee the option to repurchase the property only if the buyer-lessor has decided to sell the property and has obtained an offer from a third-party ordinarily will not result in a failed sale/purchase (assuming the other conditions outlined in ASC 842-40-25-1 and 25-2 are also met). In that scenario, the buyer-lessor controls the property through retaining the right to decide whether and when to sell the property.

### BDO INSIGHTS – RIGHT OF FIRST OFFER IN REAL ESTATE SALE AND LEASEBACK TRANSACTIONS

A right of first offer (ROFO) is most commonly structured as an option that grants the seller-lessee the right to offer to repurchase the property from the buyer-lessor. ROFOs may have varying terms and may be exercisable only after a period of time or at a specified time, and only for a fixed or determinable amount, based on a formula, or at market rates.

Whether a ROFO in a sale-leaseback transaction results in a failed sale/purchase will depend on the specific terms and conditions. Generally, if the buyer-lessor has the ability to reject the seller-lessee's offer with no significant negative economic consequences, then the existence of the ROFO will not preclude sale accounting (assuming the other conditions outlined in ASC 842-40-25-1 and 25-2 are also met). However, if the buyer-lessor would be compelled economically or contractually to accept the offer, the ROFO is equivalent to a repurchase option and would thus result in a failed sale/purchase for real estate transactions. In addition, if the seller-lessee is economically or contractually compelled to make an offer, a ROFO may be the equivalent to an obligation to repurchase the property (i.e., a forward) if the buyer-lessor is compelled to accept the offer, which also will result in a failed sale/purchase. The buyer-lessor and seller-lessee should consider all relevant factors when determining whether the buyer-lessor or the seller-lessee would be compelled to accept the offer, or make an offer, respectively. The factors outlined in ASC 842-10-55-26 typically will be useful in evaluating the existence of economic compulsion.

#### 7.2.4 Accounting When Transfer of the Asset Is a Sale

##### 7.2.4.1 Recognition

If after analyzing the terms as noted in the previous sections it is determined that the transfer of the asset is a sale, the sale of the asset and subsequent leaseback are accounted for independently, with the leaseback accounted for as any other lease under ASC 842 by each party.

When the transaction is at market terms, the following occurs at the date the buyer-lessor obtains control of the asset:

| THE SELLER-LESSEE   | THE BUYER-LESSOR  |
|---|---|
| <ul style="list-style-type: none"> <li>▶ Derecognizes the carrying amount of the underlying asset,</li> <li>▶ Recognizes the transaction price in accordance with ASC 606-10-32-2 through 32-27,</li> <li>▶ Recognizes a gain or loss for the difference between the transaction price and carrying amount of the asset,</li> <li>▶ Accounts for the leaseback in accordance with ASC 842-20 on lessee accounting (see Chapter 5).</li> </ul> | <ul style="list-style-type: none"> <li>▶ Accounts for the purchase of the asset in accordance with other GAAP (typically ASC 360),</li> <li>▶ Accounts for the leaseback in accordance with ASC 842-30 on lessor accounting (see Chapter 6).</li> </ul> |

The following Examples illustrate the accounting for various sale and leaseback transactions under different scenarios. Please note that for the illustrations throughout this chapter, the tables presented in each Example are consistent with how they would be displayed in a spreadsheet, with amounts shown with no decimals, and no rounding function used.

#### EXAMPLE 6A: SALE-LEASEBACK TRANSACTION WHEN TRANSFER OF ASSET IS A SALE

##### FACTS

- ▶ Seller-Lessee sells an airplane to an unrelated Buyer-Lessor for \$3.0 million, which is its fair value.
- ▶ The carrying amount of the airplane is \$2.7 million and it has a remaining useful life of 15 years.
- ▶ At the same time, Seller-Lessee enters into a contract with Buyer-Lessor for the right to use the airplane for 5 years, with annual payments of \$300,000 payable in arrears and escalating 2% annually.
- ▶ The leaseback does not transfer ownership to Seller-Lessee at the end of the lease term and does not include a purchase option. There are no initial direct costs.
- ▶ Assume that the requirements in ASC 606 on contract existence and transfer of control are met and that the leaseback is classified as an operating lease by both Seller-Lessee and Buyer-Lessor.
- ▶ Seller-Lessee's incremental borrowing rate is 4%. The rate implicit in the lease is not readily determinable.

##### ANALYSIS

###### Assessing whether the transfer of the asset is a sale

- ▶ Seller-Lessee and Buyer-Lessor determine that the transfer of the asset is a sale. This is because:
  - The requirements in ASC 606 on contract existence and transfer of control are met,
  - The leaseback is classified as an operating lease,
  - There is no repurchase option.

###### Accounting by Seller-Lessee

- ▶ At the commencement date, Seller-Lessee records the following journal entry:

|                                  | \$ | \$        |
|----------------------------------|----|-----------|
| Dr. Cash                         |    | 3,000,000 |
| Cr. Property, plant or equipment |    | 2,700,000 |
| Cr. Gain on sale                 |    | 300,000   |

- ▶ Seller-Lessee also recognizes a lease liability for the leaseback at the present value of the lease payments, discounted using its incremental borrowing rate of 4%, which results in an initial lease liability of \$1,387,891 calculated as follows:

| PMT                      |                  |
|--------------------------|------------------|
| Year 1                   | 300,000          |
| Year 2                   | 306,000          |
| Year 3                   | 312,120          |
| Year 4                   | 318,362          |
| Year 5                   | 324,730          |
| <b>Undiscounted PMTs</b> | <b>1,561,212</b> |
| <b>PV(4%) =</b>          | <b>1,387,891</b> |

- ▶ The initial measurement of the right-of-use asset is the same as the lease liability since there are no prepayments, lease incentives, or initial direct costs.
- ▶ Seller-Lessee calculates the total lease cost to be recognized over the lease term:

|  |                     |
|--|---------------------|
| Total lease payments (paid and not yet paid) | \$ 1,561,212        |
| Plus, initial direct costs                   | <u>—</u>            |
| Total lease cost [A]                         | <u>\$ 1,561,212</u> |
| Periodic lease cost [B] = [A] / 5            | <u>\$ 312,242</u>   |

- ▶ The following table summarizes the accounting for the lease liability, assuming no modifications.

|        | Beg.<br>Balance | Interest<br>(4%) | PMT       | Closing<br>Balance |
|--------|-----------------|------------------|-----------|--------------------|
| Year 1 | 1,387,891       | 55,516           | (300,000) | 1,143,407          |
| Year 2 | 1,143,407       | 45,736           | (306,000) | 883,143            |
| Year 3 | 883,143         | 35,326           | (312,120) | 606,349            |
| Year 4 | 606,349         | 24,254           | (318,362) | 312,240            |
| Year 5 | 312,240         | 12,490           | (324,730) | —                  |

- ▶ The following table summarizes the accounting for the right-of-use asset, assuming no modifications and impairments. See Chapter 5 for additional details and explanations.

|        | Opening<br>Balance | Periodic<br>Lease Cost | Interest<br>(4%) | Amortization    | Closing<br>Balance |
|--------|--------------------|------------------------|------------------|-----------------|--------------------|
|        | [A]                | [B]                    | [C] - see above  | [D] = [B] + [C] | [A] + [D]          |
| Year 1 | 1,387,891          | (312,242)              | 55,516           | (256,727)       | 1,131,164          |
| Year 2 | 1,131,164          | (312,242)              | 45,736           | (266,506)       | 864,658            |
| Year 3 | 864,658            | (312,242)              | 35,326           | (276,917)       | 587,74             |
| Year 4 | 587,741            | (312,242)              | 24,254           | (287,988)       | 299,753            |
| Year 5 | 299,753            | (312,242)              | 12,490           | (299,753)       | —                  |

- ▶ Seller-Lessee recognizes straight-line lease expense of \$312,242 on an annual basis throughout the lease term.

#### Accounting by Buyer-Lessor

- ▶ Buyer-Lessor recognizes the airplane at cost for \$3.0 million. Buyer-Lessor subsequently accounts for the asset under ASC 360.
- ▶ Because the lease is classified as an operating lease, Buyer-Lessor recognizes lease income of \$312,242 annually, assuming collectibility of the lease payments is probable throughout the lease term. See Chapter 6 for additional details on collectibility considerations for operating leases.

#### 7.2.4.2 Off-Market Terms

The sale price and lease payments in a sale and leaseback transaction are interdependent since they are negotiated as a package. For example, the sale price might be more than the fair value of the asset because the leaseback payments are above market; or vice versa. Because this could misstate the amounts recorded by the seller-lessee and buyer-lessor, both in the day-1 accounting (the sale) and day-2 accounting (the leaseback), the FASB decided that an entity should adjust the sale (purchase) price of the asset if the sale and leaseback occurs at other than a market rate.



##### EXCEPTION EXISTS FOR RELATED PARTY SALE AND LEASEBACK TRANSACTIONS

The above guidance on adjustments for off-market terms does not apply if the transaction is between related parties. Instead, the related party lessee and lessor should make appropriate disclosures. This is consistent with the FASB's decision that an entity should account for a related party lease in accordance with the enforceable terms and conditions of that lease.

The entity determines whether the transaction is at market by comparing the difference between either of the following, whichever is more readily determinable, maximizing the use of observable prices and observable information:

- ▶ The sale price of the asset and the fair value of the asset,
- ▶ The present value of the lease payments and the present value of market rental payments.

Accordingly, an entity does not have to determine the fair value of *both* the underlying asset and the market rental payments. The FASB decided that such a requirement would likely be unnecessary given that any overpayment for the underlying asset by the buyer-lessor would often be accompanied by above market rental payments, and vice versa.



##### VARIABLE PAYMENTS ARE CONSIDERED IN IDENTIFYING OFF-MARKET TERMS

The FASB noted in ASC 842-40-30-3 and in paragraph BC365 of ASU 2016-02 that variable payments are part of the negotiated exchange between the parties and therefore should be considered in determining whether the transaction is at market. In doing so, the entity should consider those variable payments it reasonably expects to be entitled to (or to make) based on all the information (historical, current, and forecast) that is reasonably available to the entity. For a seller-lessee, this includes estimating any variable consideration it expects to be entitled in accordance with ASC 606-10-32-5 through 32-9. However, variable payments considered in this evaluation should not be recognized as part of the transaction price for the seller-lessee, the cost of the asset to the buyer-lessor or included in the seller-lessee's measurement of the lease liability, except in accordance with the guidance in ASC 842 or other Topics such as ASC 606 or ASC 360.

If there are off-market terms, the entity accounts for those as follows:

- ▶ If the sale price is below fair value, as prepaid rent because the underpayment is no different, in substance, from a prepayment of rent by the seller-lessee. The prepaid rent is recognized by the buyer-lessor as deferred rent (recognized over the lease term typically on a straight-line basis), and the lessee includes the amount as part of the initial measurement of the right-of-use asset (recognized over the lease term as part of the amortization of the right-of-use asset).
- ▶ If the sale price is above fair value, as additional financing provided by the buyer-lessor to the seller-lessee in accordance with other Topics because the overpayment is no different than the buyer-lessor granting the seller-lessee a loan in addition to purchasing the seller-lessee's asset. The buyer-lessor and seller-lessee recognize a financial receivable and financial liability, respectively, and allocate the payments under the contract between the lease and financing components.

See ASC 842-40-55 Example 1 for an illustration of the accounting by both the seller-lessee and buyer-lessor for off-market terms. See also Examples 6B and 6C below.

**EXAMPLE 6B - SALE-LEASEBACK TRANSACTION WITH OFF MARKET TERMS - SALE PRICE EXCEEDS FAIR VALUE****FACTS**

- ▶ Assume the same facts as in Example 6A, except that Seller-Lessee sells the airplane to Buyer-Lessor for \$3.5 million. The observable fair value of the airplane is \$3.0 million. Because the fair value of the airplane is observable, Seller-Lessee and Buyer-Lessor use that benchmark to evaluate whether the sale is at market terms.
- ▶ The leaseback includes annual payments of \$310,000 payable in arrears.

**ANALYSIS**Assessing whether the transfer of the asset is a sale

- ▶ Consistent with Example 6A, the Seller-Lessee and Buyer-Lessor determine that the transfer of the asset is a sale. The changes in sale price and contractual lease payments did not change the conclusion.

Accounting by Seller-Lessee

- ▶ At the commencement date, Seller-Lessee records the following journal entry:

|                                  | \$        | \$        |
|----------------------------------|-----------|-----------|
| Dr. Cash                         | 3,500,000 |           |
| Cr. Property, plant or equipment |           | 2,700,000 |
| Cr. Gain on sale                 |           | 300,000   |
| Cr. Financial liability          |           | 500,000   |

- ▶ Seller-Lessee then determines the contractual payments attributable to repayment of the additional financing; that is, the amount of each annual payment that must be attributed to repayment of the financial liability for that liability to reduce to zero at the end of the lease term.
- ▶ Seller-Lessee could calculate that amount using either of the following approaches, which should result in the same amounts allocated:
  - Using the PMT function in Excel based on the payment terms and conditions of the lease, which in this example results in \$112,314 annual payments attributed to the financial obligation, or
  - Allocating the payments based on the relative basis of the initial lease liability and financial liability recognized. In doing so, Seller-Lessee would calculate the lease liability as the present value of five payments of \$310,000 discounted at 4% (which amounts to \$1,380,065) less the initial amount of the financial liability of \$500,000, resulting in a lease liability of \$880,065. Seller-Lessee would allocate the contractual payments as follows:

|                     | Measurement      | Percentage | Allocation     |
|---------------------|------------------|------------|----------------|
| Lease liability     | 880,065          | 63.77%     | 197,686        |
| Financial liability | 500,000          | 36.23%     | 112,314        |
| <b>Total</b>        | <b>1,380,065</b> |            | <b>310,000</b> |

- The following table summarizes the accounting for the financial liability throughout the lease term.

|        | Beg.<br>Balance | Interest<br>(4%) | PMT       | Closing<br>Balance |
|--------|-----------------|------------------|-----------|--------------------|
| Year 1 | 500,000         | 20,000           | (112,314) | 407,686            |
| Year 2 | 407,686         | 16,307           | (112,314) | 311,680            |
| Year 3 | 311,680         | 12,467           | (112,314) | 211,834            |
| Year 4 | 211,834         | 8,473            | (112,314) | 107,994            |
| Year 5 | 107,994         | 4,320            | (112,314) | —                  |

- Seller-Lessee also recognizes a lease liability for the leaseback at the present value of the contractual payments attributable to the lease of \$197,686 (\$310,000 annual payment less \$112,314 attributed to the financial liability). The following table summarize the accounting for the lease liability, assuming no modifications.

|        | Beg.<br>Balance | Interest<br>(4%) | PMT       | Closing<br>Balance |
|--------|-----------------|------------------|-----------|--------------------|
| Year 1 | 880,065         | 35,203           | (197,686) | 717,581            |
| Year 2 | 717,581         | 28,703           | (197,686) | 548,598            |
| Year 3 | 548,598         | 21,944           | (197,686) | 372,855            |
| Year 4 | 372,855         | 14,914           | (197,686) | 190,083            |
| Year 5 | 190,083         | 7,603            | (197,686) | —                  |

- The following table summarizes the accounting for the right-of-use asset, assuming no modifications and impairments. See Chapter 5 for additional details and explanations.

|        | Opening<br>Balance | Periodic<br>Lease Cost | Interest<br>(4%) | Amortization    | Closing<br>Balance |
|--------|--------------------|------------------------|------------------|-----------------|--------------------|
|        | [A]                | [B]                    | [C] - see above  | [D] = [B] + [C] | [A] + [D]          |
| Year 1 | 880,065            | (197,686)              | 35,203           | (162,484)       | 717,581            |
| Year 2 | 717,581            | (197,686)              | 28,703           | (168,983)       | 548,598            |
| Year 3 | 548,598            | (197,686)              | 21,944           | (175,743)       | 372,855            |
| Year 4 | 372,855            | (197,686)              | 14,914           | (182,772)       | 190,083            |
| Year 5 | 190,083            | (197,686)              | 7,603            | (190,083)       | —                  |

- Seller-Lessee recognizes straight-line lease expense of \$197,686 along with interest expense on the financial liability (for example, \$20,000 in Year 1) throughout the lease term.

#### Accounting by Buyer-Lessor

- Buyer-Lessor recognizes the airplane at a cost of \$3.0 million. Buyer-Lessor subsequently accounts for the asset under ASC 360.
- Buyer-Lessor recognizes a financial asset for the additional financing provided to Seller-Lessee in the amount of \$500,000.
- Buyer-Lessor determines an interest rate in accordance with ASC 835-30-25-12 and 25-13 and allocates the contractual payments between the leaseback and financial asset. The contractual payments attributable to repayment of the additional financing is the amount of each annual payment that must be attributed to the financial asset for that asset to reduce to zero at the end of the lease term (consistent with how it was calculated for Seller-Lessee above).
- Buyer-Lessor will also recognize lease income and interest income based on the amounts attributed to the leaseback and financial asset.

**EXAMPLE 6C - SALE-LEASEBACK TRANSACTION WITH OFF MARKET TERMS - SALE PRICE IS LESS THAN FAIR VALUE****FACTS**

- ▶ Assume the same facts as in Example 6A, except that Seller-Lessee sells the airplane to Buyer-Lessor for \$2.5 million. The observable fair value of the airplane is \$3.0 million. Because the fair value of the airplane is observable, Seller-Lessee and Buyer-Lessor use that benchmark in evaluating whether the sale is at market terms.
- ▶ The leaseback includes annual payments of \$290,000 payable in arrears.

**ANALYSIS**Assessing whether the transfer of the asset is a sale

- ▶ Consistent with Example 6A, the Seller-Lessee and Buyer-Lessor determine that the transfer of the asset is a sale. The changes in sale price and contractual lease payments did not change the conclusion.

Accounting by the Seller-Lessee

- ▶ Because the sale price is less than the fair value of the plane, Seller-Lessee accounts for the difference of \$500,000 as a prepayment of rent.
- ▶ Seller-Lessee recognizes a lease liability for the leaseback at the present value of the unpaid lease payments, discounted using its incremental borrowing rate of 4%, which results in an initial lease liability of \$1,291,028 calculated as follows:

| PMT                      |                  |
|--------------------------|------------------|
| Year 1                   | 290,000          |
| Year 2                   | 290,000          |
| Year 3                   | 290,000          |
| Year 4                   | 290,000          |
| Year 5                   | 290,000          |
| <b>Undiscounted PMTs</b> | <b>1,450,000</b> |
| <b>PV(4%) =</b>          | <b>1,291,028</b> |

- ▶ The initial measurement of the right-of-use asset is the same as the lease liability plus the prepayment of \$500,000. There are no lease incentives, nor initial direct costs, and therefore the initial amount of the right-of-use asset is \$1,791,028 ( $1,291,028 + 500,000$ ).
- ▶ At the commencement date, Seller-Lessee records the following journal entry:

|                                  | \$ | \$        |
|----------------------------------|----|-----------|
| Dr. Cash                         |    | 2,500,000 |
| Dr. Right-of-use asset           |    | 1,791,028 |
| Cr. Property, plant or equipment |    | 2,700,000 |
| Cr. Lease liability              |    | 1,291,028 |
| Cr. Gain on sale                 |    | 300,000   |

- Seller-Lessee calculates the total lease cost to be recognized over the lease term:

|   |                    |
|---|--------------------|
| Total lease payments (not yet paid)         | \$1,450,000        |
| Prepayment of rent (i.e., off market terms) | 500,000            |
| Plus, initial direct costs                  | —                  |
| Total lease cost [A]                        | <u>\$1,950,000</u> |
| <b>Periodic lease cost [B] = [A] / 5</b>    | <b>\$390,000</b>   |

- The following table summarizes the accounting for the lease liability, assuming no modifications.

|        | Beg.<br>Balance | Interest<br>(4%) | PMT       | Closing<br>Balance |
|--------|-----------------|------------------|-----------|--------------------|
| Year 1 | 1,291,028       | 51,641           | (290,000) | 1,052,670          |
| Year 2 | 1,052,670       | 42,107           | (290,000) | 804,776            |
| Year 3 | 804,776         | 32,191           | (290,000) | 546,967            |
| Year 4 | 546,967         | 21,879           | (290,000) | 278,846            |
| Year 5 | 278,846         | 11,154           | (290,000) | —                  |

- The following table summarizes the accounting for the right-of-use asset, assuming no modifications and impairments.

|        | Opening<br>Balance | Periodic<br>Lease Cost | Interest<br>(4%) | Amortization    | Closing<br>Balance |
|--------|--------------------|------------------------|------------------|-----------------|--------------------|
|        | [A]                | [B]                    | [C] - see above  | [D] = [B] + [C] | [A] + [D]          |
| Year 1 | 1,791,028          | (390,000)              | 51,641           | (338,359)       | 1,452,670          |
| Year 2 | 1,452,670          | (390,000)              | 42,107           | (347,893)       | 1,104,776          |
| Year 3 | 1,104,776          | (390,000)              | 32,191           | (357,809)       | 746,967            |
| Year 4 | 746,967            | (390,000)              | 21,879           | (368,121)       | 378,846            |
| Year 5 | 378,846            | (390,000)              | 11,154           | (378,846)       | —                  |

- Seller-Lessee recognizes straight-line lease expense of \$390,000 on an annual basis throughout the lease term.

#### Accounting by the Buyer-Lessor

- Buyer-Lessor recognizes the airplane at cost for \$3.0 million. Buyer-Lessor subsequently accounts for the asset under ASC 360.
- Buyer-Lessor recognizes deferred rent in the amount of \$500,000 at the commencement date.
- Because the lease is classified as an operating lease, Buyer-Lessor recognizes lease income of \$390,000 annually (the sum of the unpaid lease payments and the prepayment, divided by five), assuming collectibility of the lease payments is probable throughout the lease term. See Chapter 6 for additional details on collectibility considerations for operating leases.

## 7.2.5 Accounting When Transfer of the Asset Is Not a Sale

### 7.2.5.1 Recognition

If the transfer is not a sale, the transaction is accounted for as a financing by *both* the seller-lessee and buyer-lessor.

| THE SELLER-LESSEE  | THE BUYER-LESSOR  |
|--|---|
| <ul style="list-style-type: none"> <li>▶ Continues to recognize the transferred asset, and to apply ASC 360 (depreciation, impairment, etc.),</li> <li>▶ Accounts for amounts received as a financial liability in accordance with other Topics,</li> <li>▶ Allocates rent payments made between interest expense and principal amortization.</li> </ul> | <ul style="list-style-type: none"> <li>▶ Does not recognize the transferred asset under ASC 360,</li> <li>▶ Accounts for amounts paid as a receivable in accordance with other Topics,</li> <li>▶ Allocates rent payments received between interest income and principal amortization.</li> </ul> |

### 7.2.5.2 Seller-Lessee Adjustments to Interest Rate on Financial Liability

A seller-lessee (but not a buyer-lessor) should adjust the interest rate on the financial liability as necessary to avoid negative amortization of the financial liability and a built-in-loss when the asset is derecognized. This is achieved by determining that both:

- ▶ Interest on the financial liability is not greater than the payments over the shorter of the lease term and the term of the financing. The term of the financing could be shorter, for example, when a repurchase option that precluded sale accounting expires before the end of the lease term. In considering this requirement, we believe it applies over the *entire* lease term or term of the financing rather than to individual periods.
- ▶ The carrying amount of the asset does not exceed the carrying amount of the financial liability at the earlier of the end of the lease term and the date at which control of the asset transfers to the buyer-lessor. That is, there is no built-in loss at the earlier of the end of the lease term or the term of the financing.



#### EXCEPTION EXISTS FOR CERTAIN SALE AND LEASEBACKS

We believe the above requirements apply only to situations in which control of the asset is expected to transfer to the buyer-lessor at some point. If for example the leaseback includes a lessee option to repurchase the asset at the end of the lease term that is reasonably certain of exercise, we believe the seller-lessee should impute interest at a rate that amortizes the financial liability at the end of the lease term to the price of the repurchase option. That is, there should be no gain or loss recognized at the end of the leaseback term because control of the asset is not expected to transfer to the buyer-lessor at any point. See Example 7D for illustration.

### 7.2.5.3 Accounting at the Date Buyer-Lessor Obtains Control

At the end of the leaseback period (or at the date the buyer-lessor obtains control of the underlying asset), the seller-lessee recognizes any remaining balance of the financial liability as proceeds from the sale of the asset. The gain, if any, that is recognized reflects any difference between those proceeds and the carrying amount of the asset at that date. The buyer-lessor derecognizes the carrying amount of its financial asset and recognizes the transferred asset at that same amount. This accounting is consistent with Example 2 in ASC 842-40-55.

As discussed earlier, in a failed sale and leaseback transaction the buyer-lessor may obtain control of the underlying asset before the end of the leaseback (for example, when a repurchase option that precluded sale accounting expires before the end of the leaseback term). Example 2 in ASC 842-40-55 illustrates the accounting both initially and once the purchase option expires. However, this example has led to a number of questions, including whether lease classification should be reassessed once the repurchase option expires. Accordingly, care should be given in those situations, and entities are encouraged to discuss these situations with their accounting advisor or auditor.

### EXAMPLE 7A - ACCOUNTING FOR FAILED SALE-LEASEBACK

#### FACTS

- ▶ Seller-Lessee sells an airplane to an unrelated Buyer-Lessor for \$3 million, which is its fair value.
- ▶ The carrying amount of the airplane is \$2.7 million and it has a remaining useful life of 15 years.
- ▶ At the same time, Seller-Lessee enters into a contract with Buyer-Lessor for the right to use the airplane for 5 years, with annual payments of \$300,000 payable in arrears and escalating 2% annually.
- ▶ Seller-Lessee has a fixed price repurchase option at the end of year 5 for \$1.8 million, which Seller-Lessee is not reasonably certain to exercise.
- ▶ Absent the repurchase option, there are no other terms or conditions that would preclude sale accounting.
- ▶ Seller-Lessee's incremental borrowing rate is 4%.

#### ANALYSIS

- ▶ The exercise price of the repurchase option is fixed and therefore precludes accounting for the transaction as a sale.
- ▶ Seller-Lessee therefore accounts for the \$3 million of proceeds received as a financial liability, and it utilizes its incremental borrowing rate of 4% to recognize interest expense.
- ▶ Seller-Lessee also continues to recognize the asset and continues to depreciate it over the remainder of its useful life (assume depreciation expense is \$180,000 annually).
- ▶ Seller-Lessee's accounting for the financial liability and asset are determined as follows:

|        | Beg. Liability Balance<br>[A] | Interest<br>[B] = [A] × 4.00% | PMT       | End. Liability Balance<br>[D] = [A] + [B] + [C] | End. Asset Balance |
|--------|-------------------------------|-------------------------------|-----------|---|--------------------|
| Year 1 | 3,000,000                     | 120,000                       | (300,000) | 2,820,000                                       | 2,520,000          |
| Year 2 | 2,820,000                     | 112,800                       | (306,000) | 2,626,800                                       | 2,340,000          |
| Year 3 | 2,626,800                     | 105,072                       | (312,120) | 2,419,752                                       | 2,160,000          |
| Year 4 | 2,419,752                     | 96,790                        | (318,362) | 2,198,180                                       | 1,980,000          |
| Year 5 | 2,198,180                     | 87,927                        | (324,730) | 1,961,377                                       | 1,800,000          |



Seller-Lessee determines that there is no negative amortization of the financial liability and no built-in-loss at the end of the lease term (financing term). Therefore, no further adjustments to the interest rate are required.

- ▶ Buyer-Lessor also accounts for the transaction as a financing and determines an appropriate interest rate in accordance with ASC 835-30-25-12 and 25-13.
- ▶ If at the end of Year 5 the repurchase option is not exercised and expires, Seller-Lessee recognizes the sale of the asset by derecognizing the underlying asset for \$1.8 million, derecognizing the carrying amount of the financial liability of \$1.96 million, and recognizing a gain of \$161,377. Buyer-Lessor recognizes the underlying asset at the amount of its financial receivable at that date.

### EXAMPLE 7B - ACCOUNTING FOR FAILED SALE-LEASEBACK BY SELLER-LESSEE - NEGATIVE AMORTIZATION

#### FACTS

- ▶ Assume the same facts as Example 7A above, except that the payments are \$105,000 annually, payable in arrears.

#### ANALYSIS

- ▶ As stated in Example 7A, this transaction is considered a financing transaction.
- ▶ Seller-Lessee's accounting for the financial liability and asset are determined as follows:

|        | Beg. Liability Balance<br>[A] | Interest<br>[B] = [A] x 4.00% | PMT<br>[C] | End. Liability Balance<br>[D] = [A] + [B] + [C] | End. Asset Balance |
|--------|-------------------------------|-------------------------------|------------|---|--------------------|
| Year 1 | 3,000,000                     | 120,000                       | (105,000)  | 3,015,000                                       | 2,520,000          |
| Year 2 | 3,015,000                     | 120,600                       | (105,000)  | 3,030,600                                       | 2,340,000          |
| Year 3 | 3,030,600                     | 121,224                       | (105,000)  | 3,046,824                                       | 2,160,000          |
| Year 4 | 3,046,824                     | 121,873                       | (105,000)  | 3,063,697                                       | 1,980,000          |
| Year 5 | 3,063,697                     | 122,548                       | (105,000)  | 3,081,245                                       | 1,800,000          |



Seller-Lessee determines that there is no built-in-loss at the end of the lease term (financing term). However, there is negative amortization of the financial liability (the aggregate interest expense over the 5-year period exceeds the aggregate payments made). Therefore, Seller-Lessee is required to adjust the interest rate.

- ▶ Seller-Lessee therefore determines an adjusted interest rate that does not result in negative amortization of the financial liability. In this case, it is 3.50% (i.e., \$105,000 annual payment divided by the initial financial liability of \$3,000,000). The updated balances are as follows:

|        | Beg. Liability Balance<br>[A] | Interest<br>[B] = [A] x 3.50% | PMT<br>[C] | End. Liability Balance<br>[D] = [A] + [B] + [C] | End. Asset Balance |
|--------|-------------------------------|-------------------------------|------------|---|--------------------|
| Year 1 | 3,000,000                     | 105,000                       | (105,000)  | 3,000,000                                       | 2,520,000          |
| Year 2 | 3,000,000                     | 105,000                       | (105,000)  | 3,000,000                                       | 2,340,000          |
| Year 3 | 3,000,000                     | 105,000                       | (105,000)  | 3,000,000                                       | 2,160,000          |
| Year 4 | 3,000,000                     | 105,000                       | (105,000)  | 3,000,000                                       | 1,980,000          |
| Year 5 | 3,000,000                     | 105,000                       | (105,000)  | 3,000,000                                       | 1,800,000          |

- ▶ If at the end of Year 5 the repurchase option is not exercised and expires, Seller-Lessee recognizes the sale of the asset by derecognizing the underlying asset for \$1.8 million, derecognizing the carrying amount of the financial liability of \$3.0 million, and recognizing a gain of \$1.2 million.

### EXAMPLE 7C - ACCOUNTING FOR FAILED SALE-LEASEBACK BY SELLER-LESSEE - BUILT-IN-LOSS

#### FACTS

- ▶ Assume the same facts as Example 7A above, except that the payments are \$375,000 annually, payable in arrears.

#### ANALYSIS

- ▶ As stated in Example 7A, this transaction is considered a financing transaction.
- ▶ Seller-Lessee's accounting for the financial liability and asset are determined as follows:

|        | Beg. Liability Balance<br>[A] | Interest<br>[B] = [A] x 4.00% | PMT<br>[C] | End. Liability Balance<br>[D] = [A] + [B] + [C] | End. Asset Balance |
|--------|-------------------------------|-------------------------------|------------|---|--------------------|
| Year 1 | 3,000,000                     | 120,000                       | (375,000)  | 2,745,000                                       | 2,520,000          |
| Year 2 | 2,745,000                     | 109,800                       | (375,000)  | 2,479,800                                       | 2,340,000          |
| Year 3 | 2,479,800                     | 99,192                        | (375,000)  | 2,203,992                                       | 2,160,000          |
| Year 4 | 2,203,992                     | 88,160                        | (375,000)  | 1,917,152                                       | 1,980,000          |
| Year 5 | 1,917,152                     | 76,686                        | (375,000)  | 1,618,838                                       | 1,800,000          |



Seller-Lessee determines that there is no negative amortization of the financial liability but there is a built-in-loss at the end of Year 5 (i.e., the carrying amount of the asset exceeds the carrying amount of the financial liability). Therefore, Seller-Lessee is required to adjust the interest rate.

- ▶ Seller-Lessee therefore determines an adjusted interest rate that does not result in a built-in-loss at the end of Year 5. In this case, it is approximately 5.305% (calculated so that the financial liability equals the carrying amount of the asset at the end of the lease term).
- ▶ The updated balances are as follows:

|        | Beg. Liability Balance<br>[A] | Interest<br>[B] = [A] x<br>5.305% | PMT<br>[C] | End. Liability Balance<br>[D] = [A] + [B] + [C] | End. Asset Balance |
|--------|-------------------------------|-----------------------------------|------------|---|--------------------|
| Year 1 | 3,000,000                     | 159,149                           | (375,000)  | 2,784,149                                       | 2,520,000          |
| Year 2 | 2,784,149                     | 147,698                           | (375,000)  | 2,556,847                                       | 2,340,000          |
| Year 3 | 2,556,847                     | 135,640                           | (375,000)  | 2,317,487                                       | 2,160,000          |
| Year 4 | 2,317,487                     | 122,942                           | (375,000)  | 2,065,429                                       | 1,980,000          |
| Year 5 | 2,065,429                     | 109,570                           | (375,000)  | 1,800,000                                       | 1,800,000          |

- ▶ If at the end of Year 5 the repurchase option is not exercised and expires, Seller-Lessee recognizes the sale of the asset by derecognizing the underlying asset for \$1.8 million, derecognizing the carrying amount of the financial liability of \$1.8 million, and recognizing no gain or loss.

**EXAMPLE 7D - ACCOUNTING FOR FAILED SALE-LEASEBACK BY SELLER-LESSEE - REPURCHASE OPTION REASONABLY CERTAIN OF EXERCISE**

**FACTS**

- ▶ Assume the same facts as Example 7A above, except that the repurchase option at \$1.8 million is reasonably certain of exercise.

**ANALYSIS**

- ▶ As stated in Example 7A, this transaction is considered a financing transaction.
- ▶ Because control of the asset is not expected to transfer to Buyer-Lessor at any point, there should be no gain or loss recognized by Seller-Lessee at the end of the leaseback term. Accordingly, Seller-Lessee should adjust the interest rate so that the financial liability at the end of Year 5 equals the exercise price of the purchase option. In this case, this results in an interest rate of approximately 2.838%.
- ▶ Seller-Lessee's accounting for the financial liability and asset are determined as follows:

|        | Beg. Liability Balance<br>[A] | Interest<br>$[B] = [A] \times 2.838\%$ | PMT<br>[C] | End. Liability Balance<br>[D] = [A] + [B] + [C] | End. Asset Balance |
|--------|-------------------------------|--|------------|---|--------------------|
| Year 1 | 3,000,000                     | 85,138                                 | (300,000)  | 2,785,138                                       | 2,520,000          |
| Year 2 | 2,785,138                     | 79,040                                 | (306,000)  | 2,558,178                                       | 2,340,000          |
| Year 3 | 2,558,178                     | 72,599                                 | (312,120)  | 2,318,657                                       | 2,160,000          |
| Year 4 | 2,318,657                     | 65,802                                 | (318,362)  | 2,066,096                                       | 1,980,000          |
| Year 5 | 2,066,096                     | 58,634                                 | (324,730)  | 1,800,000                                       | 1,800,000          |

- ▶ At the end of Year 5 the repurchase option is exercised. Seller-Lessee derecognizes the carrying amount of the financial liability of \$1.8 million, and credits cash for the payment made to Buyer-Lessor.

## 7.3 BUSINESS COMBINATIONS (OR ACQUISITIONS BY NOT-FOR-PROFIT ENTITIES)

There are several areas for which the accounting for leases acquired in a business combination or an acquisition by a not-for-profit entity (herein referred to as business combinations) differs from the accounting for a new lease. For some of these areas ASC 805 and ASC 842 provide clear accounting guidance. For other areas the guidance, including the interaction of ASC 805 and 842, is not clear. Additionally, the guidance sometimes differs depending on whether the acquiree is a lessee or a lessor.

### 7.3.1 Lease Classification

ASC 842-10-55-11 notes that the acquirer of a lease in a business combination should retain the acquiree's previous lease classification, unless the lease is modified and that modification is not accounted for as a separate contract. This guidance applies whether the acquired entity is a lessee or a lessor. If there is a modification and the modification is not accounted for as a separate contract, the acquirer should reassess classification. See Chapter 4 for lease classification guidance. In some cases, an acquired lease may be amended to change only the name of the parties specified in the lease. We believe such changes are administrative in nature and are not a modification because they do not change the scope of or the consideration for the lease.



#### ACQUIRED LEASE CLASSIFICATION IN AN ASSET ACQUISITION

ASC 842 does not specify whether classification of an acquired lease in an asset acquisition should be reassessed or retained like in business combinations. However, an acquired lease is typically measured as if it were a new lease of the acquirer; and for a new lease, one of the steps an entity performs is assessing classification. The only explicit exception that exists is for acquired leases in a business combination. Therefore, for asset acquisitions we believe the acquiring entity should generally reassess lease classification. However, there may be differing views on this question, and entities are encouraged to discuss classification of leases acquired in an asset acquisition with their accounting consultants and auditors.

### 7.3.2 Lease Identification

While ASC 842 discusses lease classification in a business combination, it does not provide guidance on whether an acquirer should reassess an acquiree's conclusions about whether a contract is or contains a lease. However, consistent with the guidance in paragraph 842-10-15-6, which states that an entity reassesses whether a contract is or contains a lease only if the terms and conditions of the contract are changed, we believe that an acquirer should not reassess the acquiree's previous lease identification conclusion determined under ASC 842 unless the contract is modified in connection with the transaction and such modification is not accounted for as a separate contract. Reassessing lease identification may also result in a conclusion that the contract does not contain a lease at the acquisition date, thereby directly conflicting with the specific requirement to retain lease classification of the acquiree in a business combination. However, there could be additional complexity when the acquirer and acquiree have adopted ASC 842 at different dates and/or have used different transition practical expedients. Entities are encouraged to discuss those situations with their accounting consultants and auditors.

### 7.3.3 Recognition and Measurement (Acquiree is the Lessee)

The acquirer recognizes assets and liabilities arising from leases in which the acquiree is a lessee in accordance with ASC 842. That is, the acquirer recognizes a lease liability and right-of-use asset on the balance sheet. However, ASC 805-20-25-28B provides an accounting policy election in which the acquirer may elect not to recognize assets or liabilities for leases that, at the acquisition date, have a remaining lease term of 12 months or less. This includes not recognizing an intangible asset or liability for favorable or unfavorable market terms. The election to not recognize leases on balance sheet at the acquisition date is made by asset class and applies to all of an entity's acquisitions.

If the acquirer does not make the election for leases with a remaining lease term of 12 months or less above, or if the lease is more than 12 months, the acquirer must measure the acquired lease as follows:

- ▶ Notwithstanding that the classification of a lease acquired in a business combination is not reassessed (absent a modification), the acquirer must measure the lease liability at the present value of the remaining lease payments, as if the acquired lease were a new lease of the acquirer at the acquisition date.<sup>14</sup> The FASB explained in paragraph BC415 of ASU 2016-02 that measuring the acquired lease as if it were a new lease encompasses reassessing the following assumptions: the lease term, any lessee purchase options, lease payments (such as amounts probable of being owed under a residual value guarantee), and the discount rate.
- ▶ The acquirer measures the right-of-use asset at the amount of the lease liability, adjusted for any favorable or unfavorable terms (i.e., off-market terms) present in the lease. In other words, the acquirer is required to value off-market terms as before adoption of ASC 842, except that those off-market terms are now recognized as part of the initial measurement of the right-of-use asset rather than as separate intangibles.

The acquirer must also separately recognize the following, if applicable:

- ▶ Identifiable intangible assets associated with the lease, usually called an in-place lease intangible, representing market participants' willingness to pay a price for the lease, even if the lease is at market, such as the lease of gates at an airport or of prime location retail space.
- ▶ Leasehold improvements owned by the acquiree (see discussion below on subsequent measurement).

The following table summarizes the potential assets and liabilities that may be recognized for leases acquired in a business combination when the acquiree is the lessee:

| OPERATING LEASE / FINANCE LEASE |  |
|---------------------------------|--|
| <b>Assets</b>                   | <ul style="list-style-type: none"> <li>▶ Right-of-use asset (equal to lease liability adjusted for above/below market terms)</li> <li>▶ In-place lease intangible (fair value)</li> <li>▶ Leasehold improvements owned by the acquiree (fair value)</li> </ul> |
| <b>Liabilities</b>              | <ul style="list-style-type: none"> <li>▶ Lease liability (present value of the remaining lease payments, as if the lease were a new lease of the acquirer at the acquisition date)</li> </ul>  |

<sup>14</sup> The measurement of an acquired lease in a business combination represents an exception to the fair value measurement principle that is generally required for acquired assets and liabilities. The FASB determined that the benefit of measuring acquired leases at fair value would not justify the costs of collecting the data needed to apply a fair value measurement.

**BDO INSIGHTS – ACQUIRER ELECTION NOT TO RECOGNIZE LEASES WITH REMAINING LEASE TERM OF 12 MONTHS OR LESS**

As discussed previously, ASC 805-20-25-28B provides an acquirer with an accounting policy not to recognize assets or liabilities (including intangible assets or liabilities for favorable or unfavorable market terms) for leases that, at the acquisition date, have a remaining lease term of 12 months or less. This election is made by asset class and applies to all of an entity's acquisitions.

Paragraph BC415 of ASU 2016-02 explains that when the acquiree in a business combination is a lessee, the acquirer should measure the acquiree's lease liability at the present value of the remaining lease payments as if the acquired lease was a new lease at the acquisition date. It also notes that measuring the acquired lease as if it was a new lease includes reassessing the lease term. Accordingly, and while discussed in the context of measurement of an acquired lease to be recognized by an acquirer on its balance sheet, we believe that in assessing whether an acquired lease qualifies for the recognition exception the acquirer should first reassess the lease term as if it were a new lease at the acquisition date, and then should apply the policy election (if elected) to those acquired leases that have a remaining (reassessed) lease term of 12 months or less at the acquisition date.

**BDO INSIGHTS – ACCOUNTING FOR ACQUIRED OPERATING LEASES WHEN ACQUIRER IS REASONABLY CERTAIN TO EXERCISE A PURCHASE OPTION**

As previously noted, ASC 842 is clear that in a business combination the acquirer measures an acquired lease as if it were a new lease of the acquirer at the acquisition date. The acquirer therefore reassesses the lease term, purchase options, lease payments and discount rate. In doing so, the acquirer may determine at the acquisition date that it is reasonably certain to exercise a purchase option included in the acquired lease, which would result in the lease being classified as a finance lease. The acquiree may have previously determined otherwise and classified the lease as an operating lease. Also, ASC 842 is clear that the acquirer should retain the acquiree's lease classification.

Therefore, even if the acquirer's assumptions (as compared to the previous assumptions used by the acquiree) would result in a change in lease classification if assessed at the acquisition date, the acquiree's lease classification should be retained (unless the lease is modified and that modification is not accounted for as a separate contract). In those situations, the measurement of the lease liability should include the payment related to exercise of the purchase option. Additional complexities may arise in the day-2 accounting, including the period and method for amortizing the right-of-use asset and, therefore, entities are encouraged to discuss those situations with their accounting consultants and auditors.

**BDO INSIGHTS – RECOGNITION AND MEASUREMENT OF ACQUIRED LEASES WHEN ACQUIREE'S AND ACQUIRER'S POLICY ON NONSEPARATION DIFFER**

As discussed in Chapter 3, a lessee may elect a practical expedient by asset class not to separate nonlease component(s) from the associated lease component. Electing the practical expedient may in some situations change classification from operating to finance when performing the present value test in ASC 842-10-25-2(d). Also, an acquiree and acquirer may have made different elections regarding nonseparation of lease and non-lease components. For example, the acquirer may have elected the nonseparation practical expedient while the acquiree did not, or vice versa, potentially resulting in different conclusions on classification of the acquiree's leases if the acquirer's policy had been applied. Therefore, questions have arisen as to how the acquirer should classify and measure acquired leases when conforming the acquiree's accounting policies to those of the acquirer.

As discussed previously, ASC 842-10-55-11 is clear that lease classification is retained in a business combination, with the only exception being for modifications not accounted for as a separate contract. Therefore, we believe the acquirer should retain the acquiree-lessee's previous classification, even if the accounting policy between the acquiree and acquirer on nonseparation is different. However, we believe that the acquirer should conform the acquiree's policies to its own and measure the acquired lease consistent with the acquirer's own policy. Specifically:

- ▶ If the acquirer elected the nonseparation practical expedient while the acquiree did not, the acquirer should combine the acquiree's nonlease components with the associated lease component when initially measuring the acquiree's leases in its business combination accounting.
- ▶ If the acquirer did not elect the nonseparation practical expedient while the acquiree did, the acquirer should separate the acquiree's nonlease components from the associated lease component when initially measuring the acquiree's leases in its business combination accounting. One acceptable approach to separate the components would be to use standalone prices at the business combination date.

**BDO INSIGHTS – MEASUREMENT OF RELATED PARTY LEASES WITH OFF-MARKET TERMS ACQUIRED IN A BUSINESS COMBINATION**

ASC 842-10-55-12 requires leases between related parties to be accounted for based on their legally enforceable terms and conditions. ASC 842-40-30-4 also notes that for sale and leaseback transactions between related parties, the entity does not adjust the sale price for off-market terms. As a result, entities typically do not adjust their lease accounting for off-market terms in related party leases. However, we believe an exception may apply for acquired related party leases in a business combination. Specifically, the acquirer in a business combination applies ASC 805-20-25-12 (applicable to acquired operating leases) and ASC 805-20-30-24 (applicable to all leases of an acquiree-lessee) to account for all leases. Those paragraphs indicate that the acquirer should measure the right-of-use asset at the same amount as the lease liability, adjusted to reflect favorable or unfavorable terms of the lease when compared with market terms.

### 7.3.4 Recognition and Measurement (Acquiree is the Lessor)

The recognition and measurement of assets and liabilities related to an acquired lease in which the acquiree is the lessor depends on lease classification.

- ▶ For a sales-type or direct financing lease, the acquirer measures the net investment in the lease at the sum of the following:

**Lease receivable** at the present value, discounted using the rate implicit in the lease, of the following as if the acquired lease were a new lease at the acquisition date:

- ▶ The remaining lease payments,
- ▶ The amount the lessor expects to derive from the underlying asset following the end of the lease term that is guaranteed by the lessee or any other third party unrelated to the lessor



**Unguaranteed residual asset**, as the difference between the fair value of the underlying asset at the acquisition date and the carrying amount of the lease receivable

The net investment in the lease is therefore equal to the fair value of the underlying asset at the acquisition date. In calculating the acquisition-date fair value of an underlying asset that is subject to a sales-type lease or a direct financing lease by the acquiree-lessor, the acquirer should take into account the terms and conditions of the lease.

- ▶ For an operating lease, the underlying asset is recognized and measured at fair value. The fair value of the underlying asset is not affected by the lease (that is, the fair value would be the same whether or not there is an operating lease in place). Also, if the contract terms are favorable or unfavorable as compared to market terms, the acquirer should recognize an intangible asset or liability, respectively, for those off-market terms.
- ▶ Additionally, for all types of acquired leases for an acquiree-lessor, it may be appropriate to recognize identifiable intangible assets such as in-place leases or customer relationships. Any such intangible assets are recognized at fair value following the principles of ASC 805.

The following table summarizes the potential assets and liabilities that may be recognized for leases acquired in a business combination when the acquiree is the lessor:

|             | SALES-TYPE OR DIRECT FINANCE LEASE  | OPERATING LEASE  |
|-------------|---|--|
| Assets      | <ul style="list-style-type: none"> <li>▶ Net investment in the lease (lease receivable + unguaranteed residual asset)</li> <li>▶ In-place lease intangible (fair value)</li> <li>▶ Customer relationship intangible (fair value)</li> </ul> | <ul style="list-style-type: none"> <li>▶ Underlying asset (fair value)</li> <li>▶ Favorable lease terms (fair value)</li> <li>▶ In-place lease intangible (fair value)</li> <li>▶ Customer relationship intangible (fair value)</li> </ul> |
| Liabilities | <ul style="list-style-type: none"> <li>▶ Not applicable</li> </ul>  | <ul style="list-style-type: none"> <li>▶ Unfavorable lease terms (fair value)</li> </ul>   |

### 7.3.5 Leasehold Improvements Acquired in a Business Combination

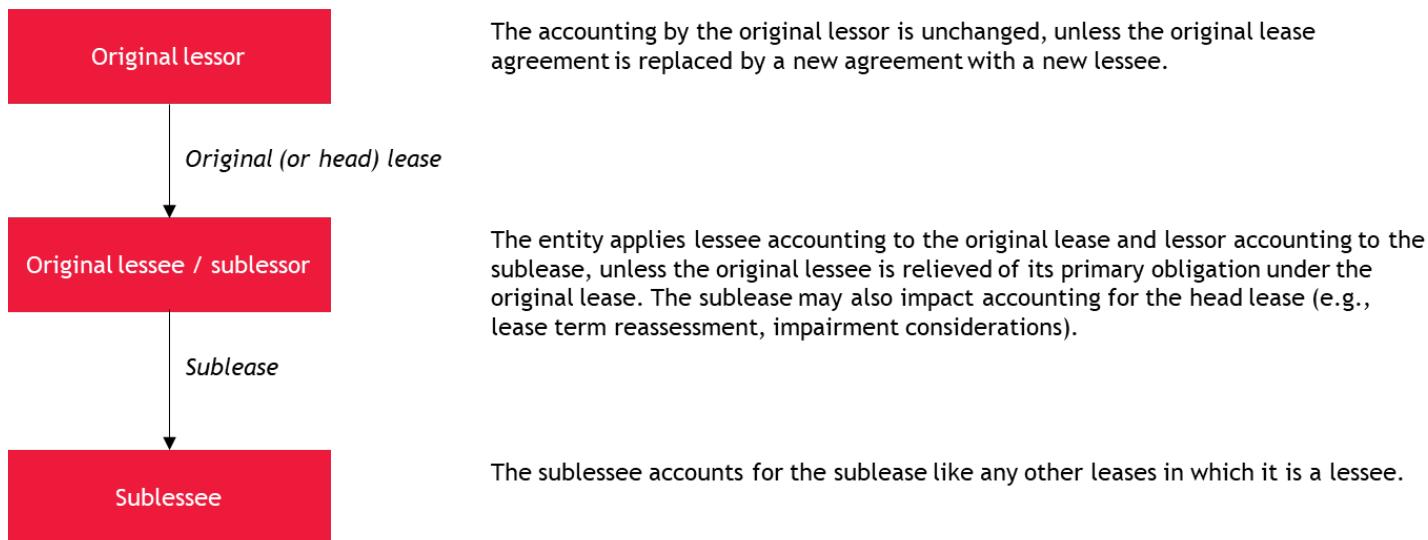
The acquirer should recognize the fair value of leasehold improvements acquired in the business combination. Additionally, ASC 842-20-35-13 requires leasehold improvements acquired in a business combination to be amortized over the shorter of the useful life of the assets and the remaining lease term at the date of acquisition. However, as discussed in ASC 805-20-35-6, if the lease transfers ownership of the underlying asset to the lessee, or the lessee is reasonably certain to exercise a purchase option, the lessee should amortize the leasehold improvements to the end of their useful life.

## 7.4 SUBLICENSES

### 7.4.1 Overview

A sublease is a transaction in which an underlying asset is re-leased by the lessee (intermediate lessor or sublessor) to a third-party (sublessee) and the original (or head) lease between the lessor and the lessee remains in effect. In the FASB's view, leases of right-of-use assets (i.e., subleases) should be accounted for in the same way as other leases. Accordingly, subleases are within the scope of ASC 842.

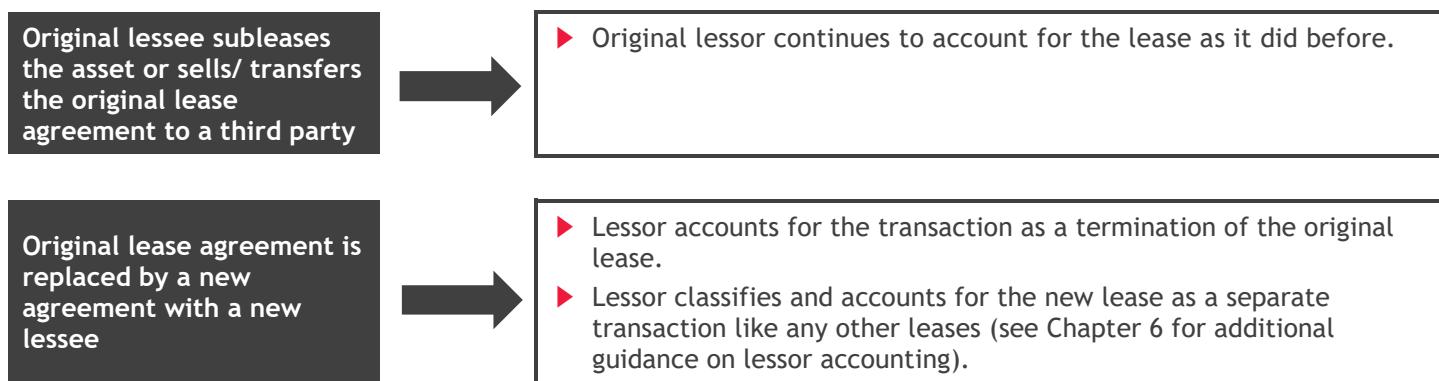
The following summarizes the accounting by each party under the original lease and/or sublease.



Disclosures related to subleases are discussed in Chapter 8.

### 7.4.2 Original Lessor Accounting

The accounting by the original lessor depends on the nature of the transaction.



### 7.4.3 Sublessee Accounting

A sublessee classifies and accounts for the sublease like any other leases as a lessee (see Chapter 5 for detailed guidance). The sublessee assesses classification of the sublease by reference to the underlying asset rather than by reference to the right-of-use asset. For example, in classifying the sublease the sublessee evaluates whether the sublease term is for a major part of the remaining economic life of the underlying asset, rather than the remaining term of the head lease.

#### 7.4.4 Sublessor Accounting

A sublessor should account for a head lease and a sublease as two separate contracts (i.e., two separate units of account) unless those contracts meet the contract combination guidance in ASC 842-10-25-19 (which we believe will be infrequent because the counterparty to the sublease is typically a different entity from the counterparty to the head lease).

The accounting by the original lessee (sublessor) depends on whether it retains the primary obligation under the original lease.

##### 7.4.4.1 Original Lessee Is Relieved of Its Primary Obligation Under Original Lease

| THE ORIGINAL LESSEE:  |
|---|
| <ul style="list-style-type: none"> <li>▶ Derecognizes the right-of-use asset and lease liability.</li> <li>▶ Recognizes any difference in profit or loss.</li> <li>▶ Includes any consideration paid or received upon termination that was not already included in the lease payments (for example, a termination payment) in the determination of profit or loss to be recognized.</li> <li>▶ Recognizes a guarantee obligation in accordance with ASC 405-20-40-2 if the original lessee is secondarily liable. In this case, the guarantee obligation is initially measured at fair value and that amount reduces the determination of profit or loss to be recognized.</li> </ul> |

##### 7.4.4.2 Original Lessee Retains Primary Obligation Under Original Lease

If the nature of a sublease is such that the original lessee is not relieved of the primary obligation under the original lease, the original lessee (as sublessor) accounts for the original lease in one of the following ways:

| ORIGINAL LEASE<br>CLASSIFICATION | SUBLEASE<br>CLASSIFICATION           | THE ORIGINAL LESSEE (SUBLESSOR):   |
|----------------------------------|--------------------------------------|--|
| Operating or finance lease       | Operating lease                      | <ul style="list-style-type: none"> <li>▶ Continues to account for the original lease as before the sublease commencement.</li> <li>▶ Recognizes sublease income over the lease term (See Chapter 6).</li> <li>▶ If the lease cost of the original lease for the term of the sublease exceeds the anticipated sublease income for the same period, that circumstance is an indicator that the carrying amount of the original lease right-of-use asset may not be recoverable in accordance with ASC 360-10-35-21.</li> <li>▶ Refer to Chapter 5 for additional complexities on application of ASC 360 to right-of-use assets when a lessee plans or enters into a sublease.</li> </ul> |
| Operating or finance lease       | Sales-type or direct financing lease | <ul style="list-style-type: none"> <li>▶ Derecognizes the original lease right of use asset.</li> <li>▶ Continues to account for the original lease liability as before the sublease commencement.</li> <li>▶ Recognizes a net investment in the sublease and any selling profit or loss consistent with the classification of the sublease (see Chapter 6).</li> <li>▶ Evaluates the net investment in the sublease for impairment like any other lessors (see Chapter 6).</li> </ul>   |

The sublessor assesses classification of the sublease by reference to the underlying asset rather than by reference to the right-of-use asset. For example, in classifying the sublease the sublessor evaluates whether the sublease term is for a major part of the remaining economic life of the underlying asset, rather than the remaining term of the head lease.

The original lessee as sublessor should also use the “rate implicit in the lease” (as defined) to determine the classification of the sublease and to measure the net investment in the sublease (if the sublease is classified as a sales-type or a direct financing lease) unless that rate cannot be readily determined. If the rate implicit in the lease cannot be readily determined, the original lessee may use the discount rate for the lease established for the original (head) lease.



#### ENTERING INTO A SUBLEASE MAY AFFECT HEAD LEASE TERM

A sublessor should consider the reassessment requirements applicable to the head lease upon entering into the sublease in accordance with ASC 842-10-35-1(a) and ASC 842-10-55-28(d). The original lessee may enter into a sublease that includes extension options that, if exercised by the sublessee, would force the original lessee to also exercise one or more extension options in the original lease. We observe that ASC 842-10-30-1 on lease term notes that periods covered by an option to extend (or not terminate) the lease in which exercise of the option is controlled by the lessor are included in the lease term. However, the FASB noted at a Board meeting that this requirement does not extend to options held by third parties (such as a sublessee). Accordingly, whether sublease options are included in the assessment of the head lease term depends on the facts and circumstances. Generally, the head lessee would be required to reassess and update the head lease term when the sublease term (determined in accordance with ASC 842-10-30-1) exceeds the remaining lease term of the head lease, as illustrated in the examples below. See Section 5.7 for additional details about reassessment events and impact on accounting for lessees.

#### EXAMPLE 8A - SUBLEASE WITH A TERM THAT EXCEEDS REMAINING LEASE TERM OF THE ORIGINAL LEASE

##### FACTS

- ▶ Dessert Co. enters into a retail store lease in a shopping mall for an initial period of four years, with two 2-year extension periods.
- ▶ At lease commencement, Dessert Co. determined that it was not reasonably certain to exercise the extension options, and therefore the lease term was four years.
- ▶ The original lease was classified as an operating lease.
- ▶ After one year into the lease, Dessert Co. enters into an agreement with Mikey’s Cookie Company to sublease the entire retail store for a noncancelable term of five years.
- ▶ Dessert Co. is not relieved of the primary obligation under the original lease.
- ▶ The sublease is determined to be an operating lease.

##### ANALYSIS

- ▶ Because Dessert Co. is still the primary obligor under the original lease, the sublease does not represent a termination of the original lease.
- ▶ Since the sublease term of 5 years exceeds the remaining lease term of the original lease of 3 years, Dessert Co. is required to reassess and update the lease term to be at least 5 years (i.e., 3 years remaining in the initial lease term plus at least one 2-year extension period). See Chapter 5 for additional guidance and impact on accounting for lessees.

**EXAMPLE 8B - SUBLEASE WITH EXTENSION OPTIONS THAT ARE NOT REASONABLY CERTAIN OF EXERCISE****FACTS**

- ▶ Assume the same facts as in Example 8A, except that the sublease with Mikey's Cookie Company has a three-year noncancelable term with two 2-year extension options.
- ▶ Dessert Co. as sublessor assessed the lease term of the sublease and determined that it is three years (i.e., Mikey's Cookie Company is not reasonably certain to exercise its extension options).

**ANALYSIS**

- ▶ The lease term for the sublease is three years, which is the remaining lease term of the original lease.
- ▶ Even though Dessert Co. would be forced to exercise its extension option(s) in the original lease if Mikey's Cookie Company were to exercise its extension option(s) in the sublease (that is, exercise of the extension options in the original lease is now outside Dessert Co.'s control), Dessert Co. determined that Mikey's Cookie Company is not reasonably certain to exercise its extension options and therefore Dessert Co. would not update the lease term of the original lease solely as a result of entering into the sublease.

**EXAMPLE 8C - SUBLEASE WITH EXTENSION OPTIONS THAT ARE REASONABLY CERTAIN OF EXERCISE****FACTS**

- ▶ Assume the same facts as in Example 8B, except that Mikey's Cookie Company is reasonably certain to exercise its first extension option.

**ANALYSIS**

- ▶ In this case, like in Example 8A the sublease term exceeds the remaining lease term of the original lease. Therefore, Dessert Co. is required to reassess and update the lease term to be at least 5 years (i.e., 3 years remaining in the initial lease term plus at least one 2-year extension period). See Chapter 5 for additional guidance and impact on accounting for lessees.

#### 7.4.4.3 Lessor Costs Paid by Sublessee Directly to Third-Party

In a sublease arrangement, the original lessee (sublessor) may require the sublessee to pay directly to the original lessor or a third-party either or both the rent payments and other costs such as property taxes and insurance otherwise due under the original lease.

ASC 842-10-15-40A requires a lessor to exclude from variable payments lessor costs paid by a lessee directly to a third party. However, costs excluded from the consideration in the contract that are paid by a lessor directly to a third party and are reimbursed by a lessee are considered lessor costs that should be accounted for by the lessor as variable payments.

This requirement also applies to a sublessor for lessor costs paid by the sublessee directly to a third-party, including the head lessor. Therefore, the accounting by the sublessor can be summarized as follows:

| SUBLESSEE PAYS LESSOR COSTS DIRECTLY TO A THIRD-PARTY, INCLUDING THE HEAD LESSOR   | SUBLESSOR PAYS COSTS AND IS REIMBURSED BY SUBLESSEE   |
|--|---|
| <ul style="list-style-type: none"><li>▶ Exclude from variable payments.</li><li>▶ In other words, treat like a sublessee cost, which does not affect the accounting for the lease.</li></ul> | <ul style="list-style-type: none"><li>▶ Account for costs excluded from consideration in the contract as lessor costs (i.e., as variable payments).</li><li>▶ In other words, recognize on a gross basis.</li></ul> |



#### EXCEPTION EXISTS FOR PAYMENTS RELATED TO RIGHT TO USE THE UNDERLYING ASSET

Importantly however, the above requirements do not apply to payments (whether fixed or variable) for the right to use the underlying asset that are paid by the sublessee directly to the original lessor. Accordingly, if the sublease requires the sublessee to make such payments directly to the original lessor, the original lessee (sublessor) should still present those amounts gross in profit or loss.

## 7.5 ACCOUNTING FOR INCOME TAXES

### 7.5.1 Overview

A leasing arrangement generally provides a financing party (the lessor) with the right to claim tax benefits from the ownership of an asset intended to be used by another party (the lessee) so that the tax benefits can be “shared” with the lessee through lower rent or lease payments. The basic tax benefit is tax deferral - i.e., accelerated tax deductions in early years to reduce income from the leasing arrangement and from other sources in exchange for more taxable income in later years when tax depreciation deductions from the leased asset are less than in early years. Additional tax benefits might include investment tax credits. ASC 740 provides for two basic principles related to the accounting for income taxes:

- |  |  |
|--|--|
| 1<br>To recognize the estimated taxes payable or refundable on tax returns for the current year as a tax liability or asset.   | For example, in a “true lease” for federal income tax purposes, a lessor would determine taxable income based on, among other things, rental income (as earned), depreciation on the asset under the Modified Accelerated Cost Recovery System, and deductible interest expense using the interest method. |
| 2<br>To recognize deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity’s financial statements or tax returns (i.e., timing differences and carryforwards). | See below for further discussion.  |

#### BDO INSIGHTS – TAX CLASSIFICATION OF LEASES

The U.S. federal income treatment or classification of leases range from a “true lease” which means the lessor is considered the tax owner of the leased property (the lessee does not own an asset for tax purposes), a conditional sale (the lessor is a conditional seller and the lessee is a conditional buyer), a lending transaction (the lessor is a creditor and the lessee is a debtor and the owner of a mortgaged asset), or other type of participation. Therefore, depending on the terms of the arrangement, the classification of a lease arrangement for federal income tax purposes could differ from the classification for financial reporting purposes.

For a true tax lease, the lessor is considered the tax owner of the leased property. As such, the lessor is entitled to tax deductions related to the ownership of the property, including depreciation and interest expense as noted above, while recognizing rental income. The primary focus of the U.S. federal tax classification analysis is whether the lessor retains sufficient risks and rewards from ownership, including consideration of whether the lessor has made a substantial equity investment and retains a meaningful interest in the residual value of the asset (i.e., whether the lessor has upside and downside residual risk in the leased property).

While U.S. federal tax law does not contain a comprehensive articulation of “true leases,” certain principles have been developed through IRS administrative guidance and case law that define a “true lease” including:

- ▶ Minimum unconditional “at risk” investment (i.e., equity investment and remaining useful life beyond lease terms),
- ▶ No bargain purchase options (i.e., less than fair market value when option is exercised) or put option to lessee,
- ▶ No economic compulsion to purchase the asset at the end of the term or at a fixed purchase option,
- ▶ No investment by lessee beyond certain improvements or additions,
- ▶ No lessee loans or guarantees,
- ▶ Profit (beyond tax benefits) and positive cash flow requirements,
- ▶ No limited use property,
- ▶ Commercially feasible that another party can use the asset after lease expiration, considering remaining useful life and residual value,
- ▶ Other considerations and facts and circumstances.

### 7.5.2 Deferred Income Taxes

The following terminologies are important for the understanding and accounting for deferred taxes:

| TEMPORARY DIFFERENCES   | DEFERRED TAX ASSETS   | DEFERRED TAX LIABILITIES   |
|---|---|--|
| Relate to the difference between the tax basis of an asset or liability and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount is recovered or settled. | Result from <i>deductible</i> temporary differences that exist at the end of a period and are measured using enacted tax rates and provisions of the enacted tax law. | Result from <i>taxable</i> temporary differences that exist at the end of a period and are measured using enacted tax rates and provisions of the enacted tax law. |

The issuance of ASC 842 did not change the principles for income tax accounting for leases. As such, the requirement to recognize deferred taxes for timing differences remains the same.

- ▶ For some leases, there will be no significant changes to the accounting for income taxes. For example, ASC 842 does not have a significant impact on the accounting requirements for lessors or lessees for finance leases. As such, there is not a significant change in the accounting for income taxes related to these leases.
- ▶ For other leases, there will be a greater impact. Most notably, since ASC 842 now requires lessees to recognize lease liabilities and right-of-use assets on the balance sheet for operating leases, the adoption of ASC 842 will, in most cases, require lessees to record new deferred tax assets and liabilities. Notwithstanding, transitioning to ASC 842 will not impact how leases are classified for federal income tax purposes.

#### BDO INSIGHTS – NEW DEFERRED TAXES FOR LESSEE OPERATING LEASES UNDER ASC 842

For book purposes under ASC 842, a lessee in an operating lease recognizes a lease liability and a right-of-use asset at the commencement date, except for short-term leases. However, for tax purposes, if the lease is considered a true lease, there will be zero tax basis for the lease liability and right-of-use asset. This creates two separate temporary differences for which deferred taxes must be recognized. Specifically, a lessee in an operating lease recognizes:

- ▶ A deferred tax liability (measured at the applicable tax rate) for the right-of-use asset since future recovery of the book basis (i.e., generating cash inflows from the use of the leased asset) will not have a corresponding depreciable tax basis, thereby resulting in more taxable income to the lessee.
- ▶ A deferred tax asset (measured at the applicable tax rate) for the lease liability because the future settlement of the lease liability (i.e., paying down the carrying value or principal) will result in a tax deduction through deductible rents.

Also, the subsequent measurement of the lease liability and right-of-use asset will often diverge, and thus the respective deferred taxes will not entirely offset.

These temporary differences must be tracked separately for disclosure purposes (as gross deferred tax assets and liabilities must be separately disclosed) and, because the reversal pattern for the deferred tax liabilities will likely be different than the reversal pattern for the deferred tax assets, this could impact the measurement of valuation allowances.

A deferred tax asset is assessed, together with all other deferred tax assets within a jurisdiction or a taxpaying entity, for realizability. However, the deferred tax liability for the right-of-use asset would generally be considered a source of income to support realization of the deferred tax asset.

The magnitude of the deferred taxes recognized initially will depend on several factors, including the length of the lease term, significance of lease payments, and the lessee's accounting policy election related to not separating non-lease components (such as maintenance services) from the related lease component, as discussed in Chapter 3. For example, a lessee that elected for its equipment asset class to not separate the non-lease components (maintenance) from the related equipment lease component will include the maintenance payments in the measurement of the lease liability and right-of-use asset that would otherwise be allocated to the maintenance component. For tax purposes, the standalone value of the non-lease component (the maintenance service) would not

be capitalized as part of the cost basis of leased property; rather, any prepayment of non-lease components could be capitalized as a separate asset and amortized over time. However, in some cases, non-lease components could also be deducted as incurred depending on the terms of the agreement and the taxpayer's method of accounting for such items. As such, the measurement of deferred taxes must consider all these factors.

### 7.5.3 Initial Direct Costs

For book purposes, lease origination costs that qualify as initial direct costs under ASC 842 are capitalized and recognized as an expense over the lease term. For lessees, initial direct costs are part of the right-of-use asset, irrespective of lease classification, and thus affect the measurement of the deferred taxes associated with the right-of-use asset. For lessors with operating leases, initial direct costs are capitalized as a separate asset and amortized over the lease term. As such, they will give rise to a separate temporary difference. For lessors with sales-type or direct-financing leases, initial direct costs that are deferred are automatically included in the net investment in the lease based on how the rate implicit in the lease is calculated. As such, they do not give rise to a separate temporary difference; rather they affect any deferred taxes associated with the net investment in the lease.

The definition of initial direct costs under ASC 842 is narrower than under ASC 840. Under ASC 842, initial direct costs include incremental costs of a lease that would not have been incurred if the lease had not been obtained (See Chapter 4 for additional details). Consequently, certain origination costs that previously were capitalized under ASC 840 now will be expensed under ASC 842. Also, for sales-type leases, lessors are required to expense initial direct costs for leases in which the fair value of the underlying asset differs from its carrying amount at lease commencement. For income tax purposes lease origination costs are still required to be capitalized (and amortized), thereby creating additional temporary differences and associated deferred income taxes, although federal tax law allows for an immediate deduction of de minimis costs incurred to acquire an asset (up to \$5,000 of the entire cost for taxpayers with applicable financial statements). This tax deduction allowance might be suitable for small value leases (e.g., certain office equipment and computers).

### 7.5.4 Sale-Leaseback Transactions

The accounting for sale-leaseback transactions under ASC 842 may result in temporary differences. As discussed earlier in this Chapter, ASC 842 requires the application of ASC 606 (existence of a contract and transfer of control), the lease classification guidance under ASC 842, and specific repurchase option guidance to determine whether the transaction qualifies for sale accounting. If a sale-leaseback transaction fails sale accounting, the consideration paid by the buyer-lessor for the asset is accounted for as a financing by both the seller-lessee and the buyer-lessor.

Some sale-leaseback transactions that meet the current tax law requirements for sales for seller-lessees and purchases for buyer-lessors may fail the accounting requirements above on sale accounting, creating temporary differences. For example, a seller-lessee would recognize current taxable income but would recognize a deferred tax asset for the future inclusion of book income. Conversely, certain sale-leaseback transactions involving real estate which did not qualify as sales under ASC 840 may result in sale accounting under ASC 842, also impacting deferred income taxes.

### 7.5.5 Other Considerations

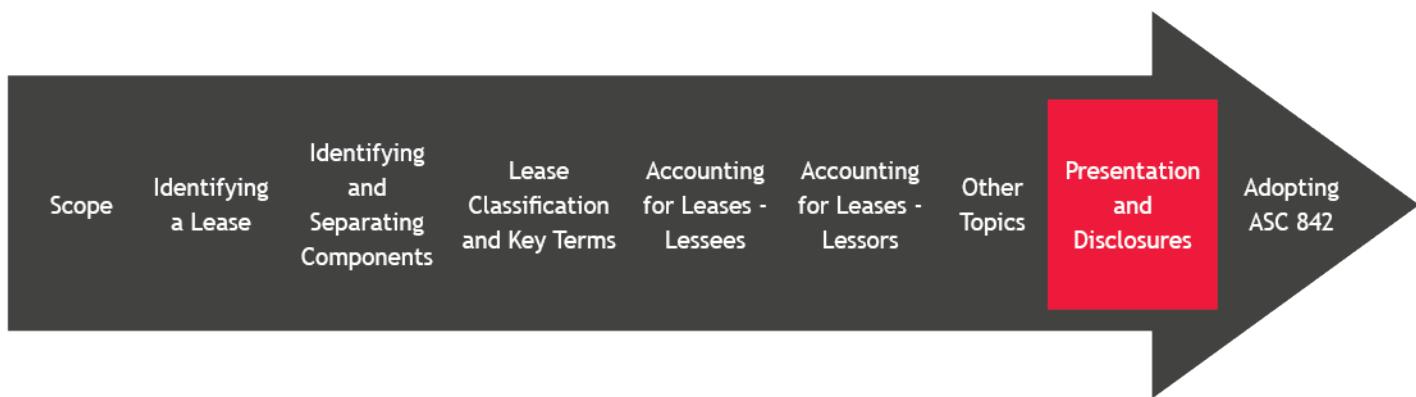
There might be current tax implications as a result of the adoption of ASC 842, such as a redetermination of state and local income taxes due to changes in apportionment factors used to allocate income to states and local jurisdictions. Additionally, the adoption of ASC 842 could cause an entity to re-evaluate its tax accounting method for leases. Currently, Section 6.03 of Rev. Proc. 2019-43 provides an automatic change procedure for taxpayers to change the classification of sale, lease or financing transactions for tax purposes.

### 7.5.6 Transfer Pricing

Intercompany transactions between related parties should meet the so-called 'arms-length' standard, which generally requires that such transactions be priced similar to how such transactions would be priced with unrelated parties. Typically, certain financial indicators are used to determine whether such transactions are at arms-length. Such indicators include return on sales, return on assets and other measures. Most often, these ratios are computed on a US GAAP basis. Due to the adoption of ASC 842, the US GAAP ratios may change, which may impact the intercompany pricing between related parties. Companies with intercompany transactions should carefully analyze the impact the new leasing standard may have on its US GAAP measures used to set its intercompany pricing.



# CHAPTER 8 – PRESENTATION AND DISCLOSURES



## 8.1 OVERVIEW

During the project leading to the new lease standard, many users indicated that the disclosure requirements in the legacy lease guidance did not provide them with enough information to understand an entity's leasing activities. As a result, ASC 842 includes enhanced disclosure requirements, including an overall disclosure objective together with expanded disclosure requirements for leases.

Consistent with the disclosure requirements in ASC 606 on revenue from contracts with customers, the FASB did not provide explicit materiality requirements. An entity will consider the disclosure objective, which is to enable users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases, and determine the level of details and emphasis needed on various disclosure requirements to satisfy the disclosure objective. The more extensive the entity's leasing activities, the more comprehensive the disclosures are expected to be.

For lessees, the FASB viewed differences in risks between leased assets and owned assets, between lease liabilities and other financial liabilities, and economic differences between operating and finance leases. Those differences drove some of the new presentation and disclosure requirements in ASC 842. Presentation of lease expense for operating leases, and amortization and interest expense for finance leases in the statement of comprehensive income is generally consistent with prior GAAP; and the presentation of cash flows arising from leases in the statement of cash flows will be driven by the presentation of lease expense in the income statement.

Meanwhile the FASB decided to retain most aspects of the lessor accounting model in previous GAAP. Therefore, lessors' presentation of leases in the statement of financial position, statement of comprehensive income, and statement of cash flows generally will not change. But many users indicated they needed more information about a lessor's leasing activities and associated risks, including credit risk related to lease receivables, and residual asset risk for the unguaranteed residual assets. ASC 842 therefore includes expanded disclosures about lessors' leasing activities.

## 8.2 PRESENTATION

### 8.2.1 Summary of Lessee Presentation Requirements

| LESSEE PRESENTATION REQUIREMENTS |   |
|----------------------------------|---|
| Balance Sheet                    | <ul style="list-style-type: none"> <li>▶ Present in the statement of financial position separately from each other and from other assets or liabilities:           <ul style="list-style-type: none"> <li>• Finance lease right-of-use assets</li> <li>• Operating lease right-of-use assets</li> <li>• Finance lease liabilities</li> <li>• Operating lease liabilities</li> </ul> </li> <li>▶ If not presented separately, disclose which line items in the statement of financial position include the right-of-use assets and lease liabilities</li> <li>▶ If not presented separately, a lessee is precluded from presenting:           <ul style="list-style-type: none"> <li>• Finance lease right-of-use assets in the same line item as operating lease right-of-use assets</li> <li>• Finance lease liabilities in the same line item as operating lease liabilities</li> </ul> </li> <li>▶ Classify right-of-use assets consistent with how other depreciating assets such as PP&amp;E are classified (i.e., as noncurrent based on ASC 210-10-45-4(f)); and classify lease liabilities as current or noncurrent consistent with the way other financial liabilities are classified</li> </ul> |
| Income Statement                 | <ul style="list-style-type: none"> <li>▶ For finance leases, present interest expense on the lease liability and amortization of the right-of-use asset in a manner consistent with how the entity presents other interest expense and depreciation or amortization of similar assets, respectively</li> <li>▶ ASC 842 does not provide specific guidance on presentation of variable lease payments for finance leases. We believe that presentation as either lease expense or interest expense may be appropriate</li> <li>▶ For operating leases, lease expense is included in income from continuing operations consistent with the presentation of other operating expenses, and should be classified within cost of sales; selling, general, and administrative expense; or another expense line item depending on the nature of the lease</li> </ul>  |
| Cash Flow Statement              | <ul style="list-style-type: none"> <li>▶ For finance leases:           <ul style="list-style-type: none"> <li>• Classify repayments of the principal portion of the lease liability within financing activities</li> <li>• Classify interest on the lease liability in accordance with requirements relating to interest paid in ASC 230 on cash flows (typically in operating activities)</li> </ul> </li> <li>▶ For operating leases, classify payments within operating activities, except if those payments represent costs to bring another asset to the condition and location necessary for its intended use, which should be classified within investing activities</li> <li>▶ For all leases, classify variable lease payments and short-term lease payments not included in the lease liability within operating activities</li> <li>▶ The establishment of ROU assets and lease liabilities at lease commencement (or that change as a result of lease modifications or reassessment events) should be disclosed as noncash investing and financing activities in accordance with ASC 210-10-50-4</li> </ul>   |

## 8.2.2 Lessee Presentation Requirements Explained

### 8.2.2.1 Balance Sheet

The FASB did not mandate separate presentation of lease amounts in the statement of financial position. However, the FASB determined that providing the carrying amount of a lessee's right-of-use assets and lease liabilities separately for finance and operating leases, and separate from other assets and liabilities will provide users with important information about an entity's use of lease arrangements in its business activities and about the relationship between the lessee's lease liabilities and right-of-use assets. Based on its outreach activities and deliberations during the project, the FASB noted that:

- ▶ There are differences between leased assets and owned nonfinancial assets (for example, there is typically no residual asset risk for a lease but there are risks associated with replacing the lease at the end of its term based on market conditions),
- ▶ A lease liability is a unique class of liability that is linked to a corresponding asset and has features, such as options and variable lease payments, that may differ from other liabilities,
- ▶ Right-of-use assets for operating and finance leases are measured differently after the commencement date (see Chapter 5), and lease costs for operating and finance leases differ in terms of recognition and presentation in the statement of comprehensive income. Therefore, separate presentation of lease liabilities for operating and finance leases will help users understand the liability balance to which the lease costs relate, and
- ▶ Presenting assets and liabilities arising from finance and operating leases in the same line item in the balance sheet would be misleading because of the differences in underlying economics of each lease type. For example, finance lease liabilities are the equivalent of debt, while operating lease liabilities are not debt-like but are operating in nature and are generally treated differently in bankruptcy.

While the FASB did not prescribe where right-of-use assets must be presented (when they are not presented separately), paragraph BC265 of ASU 2016-02 notes that in some Board members' view, "presenting operating lease assets together with owned property, plant, and equipment may be inappropriate given the Board's conclusion that operating leases convey rights and carry risks substantially different from those of owned property, plant, and equipment."

#### BDO INSIGHTS – APPROACHES FOR DETERMINING CURRENT LEASE LIABILITIES

Lease liabilities are classified as current and noncurrent in the balance sheet and subject to the same considerations as other financial liabilities when determining such classification. Therefore, lessees presenting a classified balance sheet must follow the presentation requirements in ASC 210.

Lessees present as noncurrent lease liabilities the difference between the total lease liabilities and the current portion of those lease liabilities. We believe the following approaches are acceptable for determining current lease liabilities:

- ▶ Calculate the portion of lease payments (that is, lease payments less interest accretion on the lease liability) that will reduce the lease liability balance within 12 months (or operating cycle, if longer)
- ▶ Calculate the present value of lease payments due within 12 months (or operating cycle, if longer) using the discount rate for the lease.

We also believe the approach selected for determining current lease liabilities should be consistent with the approach used to determine the current portion of other similarly calculated liabilities. For example, if a lessee uses the first approach to determine the current portion of its debt obligations and such obligations are amortized utilizing the effective interest rate method, the lessee should also use the first approach to determine the current portion of its lease liabilities.

### 8.2.2.2 Income Statement

The FASB's decisions on presentation of lease cost in the statement of comprehensive income are linked to the Board's rationale for the lessee accounting model discussed in Chapter 5.

- ▶ The FASB noted that finance leases are economically similar to the financed acquisition of other nonfinancial assets, and therefore a lessee should present amortization of the right-of-use asset and the interest on the lease liability in separate line items, similar to how an entity presents depreciation or amortization of similar assets and other interest expense.
- ▶ In some Board members' views, operating leases grant different rights to, and impose different obligations on, the lessee such that they are not economically equivalent to other acquisitions of nonfinancial assets. Also, for operating leases, a lessee should recognize a single lease cost based on the pattern in which the benefits conveyed by the lease are consumed, which is generally on a straight-line basis over the lease term. To the extent not capitalized as part of the cost of another asset, the single lease cost is included in the lessee's income from continuing operations, like under previous GAAP.

### 8.2.2.3 Cash Flow Statement

The requirements for presenting cash outflows in the statement of cash flows are linked to the presentation of expenses arising from a lease in the statement of comprehensive income and are generally consistent with prior GAAP.

## EXAMPLE 1 - STATEMENT OF CASH FLOW PRESENTATION - LESSEES

## FACTS

- ▶ Ironside Co. leases heavy machinery for its operations with a lease term of 10 years. Payments start at \$100,000 in the first year and increase by 5% annually. There are no initial direct costs, lease incentives, or prepaid lease payments.
  - ▶ Ironside Co. accounts for the lease as an operating lease and recognizes straight-line lease expense of \$125,779 annually [A].
  - ▶ The rate implicit in the lease is not readily determinable and therefore Ironside Co. uses its incremental borrowing rate, which is 6%.

## ANALYSIS

- ▶ Ironside Co. accounts for the lease as follows throughout the lease term, assuming no modifications, reassessments, or impairments. See Chapter 5 for additional guidance.

|         | Lease Liability |               |          |                 |                     | Right-of-use Asset |           |                 |
|---------|-----------------|---------------|----------|-----------------|---------------------|--------------------|-----------|-----------------|
|         | Beg. Balance    | Interest (6%) | PMT      | Closing Balance | Amort. of Liability | Beg. Balance       | Amort.    | Closing Balance |
|         | [B]             | [C]           |          | [B] + [C]       |                     | [A] - [B]          |           |                 |
| Year 1  | 904,337         | 54,260        | -100,000 | 858,598         | (45,740)            | 904,337            | (71,519)  | 832,819         |
| Year 2  | 858,598         | 51,516        | -105,000 | 805,114         | (53,484)            | 832,819            | (74,263)  | 758,556         |
| Year 3  | 805,114         | 48,307        | -110,250 | 743,170         | (61,943)            | 758,556            | (77,472)  | 681,084         |
| Year 4  | 743,170         | 44,590        | -115,763 | 671,998         | (71,172)            | 681,084            | (81,189)  | 599,895         |
| Year 5  | 671,998         | 40,320        | -121,551 | 590,767         | (81,231)            | 599,895            | (85,459)  | 514,436         |
| Year 6  | 590,767         | 35,446        | -127,628 | 498,585         | (92,182)            | 514,436            | (90,333)  | 424,103         |
| Year 7  | 498,585         | 29,915        | -134,010 | 394,491         | (104,094)           | 424,103            | (95,864)  | 328,239         |
| Year 8  | 394,491         | 23,669        | -140,710 | 277,450         | (117,041)           | 328,239            | (102,109) | 226,130         |
| Year 9  | 277,450         | 16,647        | -147,746 | 146,352         | (131,099)           | 226,130            | (109,132) | 116,998         |
| Year 10 | 146,352         | 8,781         | -155,133 | —               | (146,352)           | 116,998            | (116,998) | —               |

- ▶ Ironside Co. uses the above information to prepare its statement of cash flows. One acceptable presentation is for Ironside Co. to (1) add back the amortization of the right-of-use asset as a noncash rent expense and (2) to separately present the change in lease liability. However, other presentations may be acceptable (for example, presentation as a single net line item consistent with presentation of the single operating lease expense in the income statement). In this example, other line items are omitted, and we assume Ironside Co. has only one lease.

### 8.2.3 Summary of Lessor Presentation Requirements

| LESSOR PRESENTATION REQUIREMENTS |   |
|----------------------------------|---|
| Balance Sheet                    | <ul style="list-style-type: none"> <li>▶ Sales-type and direct financing leases           <ul style="list-style-type: none"> <li>• Present lease assets (i.e., the aggregate of the lessor's net investment in sales-type and direct financing leases) separately from other assets</li> <li>• Classify lease assets as current or noncurrent consistent with the way similar assets are classified</li> </ul> </li> <li>▶ Operating leases           <ul style="list-style-type: none"> <li>• Present the underlying asset subject to an operating lease and any lease receivable in accordance with other topics (for example, ASC 310 on Receivables or ASC 360 on PP&amp;E)</li> </ul> </li> </ul>  |
| Income Statement                 | <ul style="list-style-type: none"> <li>▶ For all leases, present income arising from leases separately, or disclose which line items in the statement of comprehensive income include lease income</li> <li>▶ For sales-type and direct financing leases, present profit or loss recognized at the commencement date in a manner that best reflects the lessor's business model, for example:           <ul style="list-style-type: none"> <li>• Present revenue and cost of goods sold in separate line items if the lessor uses leases as an alternative means of realizing value from goods it would otherwise sell (e.g., manufacturers and dealers), so that income and expenses from sold and leased items are presented consistently. Note that revenue recognized is the lesser of (1) the fair value of the underlying asset at the commencement date and (2) the sum of the lease receivable and any prepaid lease payments. Cost of goods sold is the carrying amount of the underlying asset at the commencement date minus the unguaranteed residual asset</li> <li>• Present profit or loss in a single line item if the lessor uses leases for purposes of providing finance (e.g., financial institutions)</li> </ul> </li> </ul> |
| Cash Flow Statement              | <ul style="list-style-type: none"> <li>▶ Classify cash receipts from leases within operating activities, regardless of lease classification</li> <li>▶ However, lessors within the scope of ASC 942, Financial Services - Depository and Lending, should classify principal payments received under sales-type and direct financing leases within investing activities consistent with paragraph 942-230-45-4</li> </ul>  |



#### PRESERVATION FOR REIMBURSEMENTS OF LESSOR COSTS

Some leases, such as real estate leases, require the lessee to reimburse the lessor for costs incurred related to property taxes, insurance, and maintenance services (e.g., common area maintenance). As discussed in Chapter 3, lessor costs such as property taxes and insurance that protects the lessor's asset are not a component of the contract, while maintenance services represent a nonlease component. A lessor accounts for lessor costs paid by the lessor and reimbursed by the lessee on a gross basis, and such reimbursements are allocated between the lease and nonlease components consistent with the initial (or most recent) allocation of the consideration in the contract unless the variable payments can be allocated only to the lease component. If the lessor elected the practical expedient not to separate under ASC 842-10-15-42A, and assuming the lease component is predominant, the tenant reimbursements should be presented within lease income (unless one or more nonlease components do not meet the conditions to be combined). Additional disclosures factually discussing the reimbursements may be appropriate in the notes.

## 8.2.4 Lessor Presentation Requirements Explained

### 8.2.4.1 Balance Sheet

The net investment in the lease is comprised of the following components: the lease receivable, the unguaranteed residual asset and, for direct financing leases, any deferred selling profit. In considering presentation of sales-type and direct financing leases on the balance sheet, the FASB decided against requiring a lessor to separately present the components of the net investment in the lease. Accordingly, a lessor is required to present a single net investment in sales-type and direct financing leases separately from other assets. However, certain disclosures of the lessor's investments in leases are required to provide users with information about the lessor's exposure to credit risk (for the lease receivable) and asset risk (relating to the unguaranteed residual asset). Refer to the disclosure section for additional discussion. Lease assets are financial assets that are subject to current and noncurrent presentation requirements in a classified balance sheet.

For operating leases, the assets underlying those leases and related depreciation are presented in accordance with other accounting guidance (for example, ASC 360). Also, in accordance with ASC 842-30-50-13, assets subject to operating leases should be presented separately from owned assets that are held and used by the lessor as they are subject to different risks. Any rent receivable, deferred rent revenue (that results from the requirement to recognize rents on a straight-line basis), and prepaid initial direct costs are also subject to current and noncurrent presentation requirements.

### 8.2.4.2 Income Statement

ASC 842 provides guidance on presentation in the statement of comprehensive income only for sales-type and direct financing leases. No guidance is provided for operating leases.

For sales-type and direct financing leases, the FASB noted that lessors' business models vary. For example, some like banks and other financial institutions use leasing as a means to provide financing to lessees. Others like manufacturer or dealer lessors use leasing as an alternative means of realizing value from assets they would otherwise sell (for example, medical equipment manufacturers). Accordingly, ASC 842 permits presentation of the profit recognized at the commencement date as either gross or net based on the lessor's business model.

ASC 842 does not provide specific guidance on the presentation of variable lease payments received for direct financing or sales type leases. We believe that presentation as either lease income or interest income may be appropriate.

### 8.2.4.3 Cash Flow Statement

When ASU 2016-02 was initially issued, all lessors were required to classify all cash receipts from leases as operating activities in the statement of cash flows, regardless of whether the lease was an operating lease, sales-type lease, or direct financing lease. In the FASB's view, this is because leasing is generally part of a lessor's revenue-generating activities.

However, the FASB received feedback from lessor stakeholders within the scope of ASC 942, *Financial Services—Depository and Lending*, that they historically have presented principal payments received under leases within investing activities based on an illustrative example in ASC 942 that was not eliminated with the issuance of ASC 842. Following that feedback, the FASB issued ASU 2019-01, *Codification Improvements* in March 2019 to clarify that lessors that are depository and lending institutions within the scope of ASC 942 should present all "principal payments received under leases" within investing activities. See Chapter 9 for effective dates and transition of ASU 2019-01.

## 8.3 DISCLOSURE REQUIREMENTS

### 8.3.1 Disclosure Objective Applicable to Lessees and Lessors

ASC 842-20-50-1 (applicable to lessees) and ASC 842-30-50-1 (applicable to lessors) provide that “the objective of the disclosure requirements is to enable users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases.” ASC 842-20-50-2 (applicable to lessees) and ASC 842-30-50-2 (applicable to lessors) further indicate that “a lessee [lessor] shall consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the various requirements. A lessee [lessor] shall aggregate or disaggregate disclosures so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or by aggregating items that have different characteristics.”

With that objective in mind, judgment will be required to determine the level of disclosures necessary for an entity. However, as a guiding principle, paragraph BC 276 in the Basis for Conclusions of ASU 2016-02 indicates that “if leasing is a significant part of an entity’s business activities, the disclosures would be more comprehensive than for an entity whose leasing activities are less significant....” For example, although ASC 842 does not provide specific quantitative or qualitative disaggregation requirements such as those required under ASC 606, for entities for which leasing is a significant portion of their business, such disaggregation might be appropriate.

Therefore, an entity may consider the following steps in preparing its notes to the financial statements:

*Consider information relevant to users' understanding of the amount, timing and uncertainty of cash flows from leases*



*Consider the level of detail necessary based on the significance of the entity's leasing activities*



*Provide the required disclosures about the entity's leases in sufficient detail in order to meet the disclosure objective*



Entities must make appropriate disclosures for each annual reporting period for which a statement of comprehensive income (statement of activities) is presented and in each year-end statement of financial position. Entities are not required to repeat disclosures if the information is already presented in the financial statements as required by other accounting standards.

Although the majority of the disclosures required by ASC 842 only affect an entity’s annual financial statements, the standard requires that lessors provide a table disclosing lease income for each interim and annual reporting period. Entities otherwise should look to ASC 270 on interim disclosure requirements as applicable for additional guidance. Additionally, in the year of adoption, the Securities and Exchange Commission (SEC) requires public companies to include all required annual disclosures in any interim financial statements that are prepared until the next annual financial statements are filed - even if the disclosure requirements are only applicable for annual periods. Refer to Chapter 9 for additional disclosure requirements in transition.

Unlike other recent standards, ASC 842 does not distinguish between public entities and all other entities. The disclosure principle and related requirements apply to all entities.

### 8.3.2 Lessee Disclosure Requirements

| LESSEE DISCLOSURE REQUIREMENTS |   |
|--------------------------------|---|
| Qualitative Disclosures        | <ul style="list-style-type: none"> <li>▶ Information about the nature of its leases, including:           <ul style="list-style-type: none"> <li>• A general description of those leases</li> <li>• The basis and terms and conditions on which variable lease payments are determined</li> <li>• The existence and terms and conditions of options to extend or terminate the lease. A lessee should provide narrative disclosure about the options that are recognized as part of its right-of-use assets and lease liabilities and those that are not.</li> <li>• The existence and terms and conditions of residual value guarantees provided by the lessee</li> <li>• The restrictions or covenants imposed by leases, for example, those relating to dividends or incurring additional financial obligations</li> </ul> <p style="margin-left: 20px;"><i>(A lessee should identify the information relating to subleases included in the above disclosures, as applicable)</i></p> </li> <li>▶ Information about leases that have not yet commenced but that create significant rights and obligations for the lessee, including the nature of any involvement with the construction or design of the underlying asset</li> <li>▶ Information about significant assumptions and judgments made, including:           <ul style="list-style-type: none"> <li>• The determination of whether a contract contains a lease</li> <li>• The allocation of consideration in a contract between lease and nonlease components</li> <li>• The determination of the discount rate for the lease</li> </ul> </li> </ul>  |
| Quantitative Disclosures       | <ul style="list-style-type: none"> <li>▶ For each period presented, disclose amounts related to a lessee's total lease cost (i.e., including amounts recognized in income and capitalized) and the cash flows arising from lease transactions:           <ul style="list-style-type: none"> <li>• Finance lease cost, segregated between amortization of right-of-use assets and interest on lease liabilities</li> <li>• Operating lease cost</li> <li>• Short-term lease cost, excluding expenses relating to leases with a lease term of one month or less</li> <li>• Variable lease cost</li> <li>• Sublease income, disclosed on a gross basis, separate from finance or operating lease expense</li> <li>• Net gain or loss recognized from sale and leaseback transactions</li> <li>• Amounts segregated between those for finance and operating leases for:               <ul style="list-style-type: none"> <li>• Cash paid for amounts included in the measurement of lease liabilities segregated between operating and financing cash flows</li> <li>• Supplemental noncash information on lease liabilities arising from obtaining right-of-use assets</li> <li>• Weighted-average remaining lease term, based on the remaining lease term and the lease liability balance for each lease as of the reporting date</li> <li>• Weighted-average discount rate, based on the discount rate for the lease used to calculate the lease liability balance for each lease, and remaining balance of lease payments for each lease, as of the reporting date</li> <li>• (See ASC 842-20-55-53 for an example of these disclosures)</li> </ul> </li> <li>• Disclose maturity analysis of undiscounted lease liabilities (commonly referred to as the 5-year table) separately for finance leases and operating leases, with a reconciliation of</li> </ul> </li> </ul> |

| LESSEE DISCLOSURE REQUIREMENTS                   |  |
|--|--|
| <b>Policy Elections and Practical Expedients</b> | <p>undiscounted cash flows to the finance lease liabilities and operating lease liabilities recognized in the statement of financial position</p> <ul style="list-style-type: none"> <li>▶ While the FASB included an example lessee disclosure of quantitative disclosures in ASC 842-30-55-53 (Example 6) for which the information is provided in a tabular format, the disclosure requirements in ASC 842-20-50 do not specifically require such a format</li> </ul>   |
| <b>Related Party Leases</b>                      | <ul style="list-style-type: none"> <li>▶ Disclose policy election for short-term leases, if elected           <ul style="list-style-type: none"> <li>• If the short-term lease expense does not reasonably reflect the lessee's short-term lease commitments, disclose that fact and the amount of short-term lease commitments</li> </ul> </li> <li>▶ Disclose practical expedient for not separating lease components from non-lease components, if elected, and which asset classes to which the election applies</li> <li>▶ Disclose accounting policy on using the risk-free discount rate for the lease, if elected, and which class or classes of underlying assets to which the election applies</li> </ul>  |
| <b>Sale and Leaseback Transactions</b>           | <ul style="list-style-type: none"> <li>▶ Disclose lease transactions between related parties in accordance with paragraphs 850-10-50-1 through 50-6</li> <li>▶ For common control leases, disclose the following when the useful life of leasehold improvements to the common control group exceeds the related lease term:           <ul style="list-style-type: none"> <li>• The unamortized balance of the leasehold improvements at the balance sheet date</li> <li>• The remaining useful life of the leasehold improvements to the common control group</li> <li>• The remaining lease term</li> </ul> </li> <li>▶ If a seller-lessee enters into a sale and leaseback transaction, it provides the disclosures required for lessees for the leaseback</li> <li>▶ A seller-lessee must also disclose the main terms and conditions of the sale and leaseback transaction and any gains or losses arising from the transaction separately from gains or losses on disposal of other assets</li> </ul> |



#### NONCASH INFORMATION NOT LIMITED TO LEASE LIABILITIES ARISING FROM OBTAINING ROU ASSETS

ASC 842-20-50-4(g)(2) requires disclosure of “[s]upplemental noncash information on lease liabilities arising from obtaining right-of-use assets.” In addition, ASC 230-10-50-3 requires disclosure of information about all investing and financing activities of an entity during a period that affects recognized assets or liabilities but that do not result in cash receipts or cash payments in the period. Therefore, we believe that all material noncash changes to right-of-use assets, both increases and decreases, should be disclosed, either on the face of the statement of cash flows or in the related notes. The initial recognition of a right-of-use asset should therefore be included in this disclosure, along with the following:

- ▶ Any lease modification that grants an additional right-of-use asset or removes a right-of-use asset,
- ▶ Any other remeasurement that results in increases or decreases (debits or credits) to the right-of-use asset, such as changes in the assessment of the lease term.

See Chapter 5 for additional information on modifications and remeasurement events.

**EXAMPLE 2 - LESSEE DISCLOSURE EXAMPLE**

For purposes of this example, we have assumed that Susie's Stitch-n-Sew ("Susie's") is a national retailer of fabrics and other craft materials which primarily leases its retail locations. We have not presented a statement of financial position, but have assumed that Susie's has presented the following captions:

- ▶ Operating lease ROU assets
- ▶ Fixed assets, net
- ▶ Current portion of operating lease liabilities
- ▶ Long-term operating lease liabilities
- ▶ Current portion of long-term debt
- ▶ Long-term debt

We have also not presented a statement of comprehensive income but have assumed that Susie's has presented Cost of sales, SG&A expense, Depreciation and amortization expense, and Interest expense.

This example assumes that the guidance in ASC 842 has been in effect for all periods presented, and that all amounts are in millions.

**Note X. Leases**

Susie's has historically entered into a number of lease arrangements under which we are the lessee. Specifically, of our 250 retail locations, 240 are subject to operating leases and 5 are subject to finance leases. In addition, we lease our corporate headquarters facility, as well as various warehouses and regional offices. We are also a party to an additional 12 leases in which we previously operated a retail location, but which are now subleased to third parties. In addition, we have elected the short-term lease practical expedient related to leases of various equipment used in our retail locations.

As of December 31, 20X9, we have entered into eight leases for additional retail locations and one lease for an additional warehouse which have not yet commenced. Although certain of the retail locations are currently under construction, we do not control the building during construction, and are thus not deemed to be the owner during construction.

All of our retail leases include multiple optional renewal periods. Upon opening a new retail location, we typically install brand-specific leasehold improvements with a useful life of approximately eight years. To the extent that the initial term of the related lease is less than the useful life of the leasehold improvements, we conclude that it is reasonably certain that a renewal option will be exercised, and thus that renewal period is included in the lease term, and the related payments are reflected in the ROU asset and lease liability. Generally, we do not consider any additional renewal periods to be reasonably certain of being exercised, as comparable locations could generally be identified within the same trade areas for comparable lease rates.

All of our leases include fixed rental payments, but many of our leases also include variable rental payments. Specifically, a number of our leases in certain markets require rent payments that are calculated as a percentage of sales in that location. In addition, we also commonly enter into leases under which the lease payments increase at pre-determined dates based on the change in the consumer price index. While the majority of our leases are gross leases, we also have a number of leases in which we make separate payments to the lessor based on the lessor's property and casualty insurance costs and the property taxes assessed on the property, as well as a portion of the common area maintenance associated with the property. We have elected the practical expedient not to separate lease and nonlease components for all of our building leases.

During 20X9, 20X8 and 20X7, we recognized rent expense associated with our leases as follows:

|  | 20x9                  | 20x8                  | 20x7                  |
|--|-----------------------|-----------------------|-----------------------|
| <b>Operating lease cost:</b>               |                       |                       |                       |
| Fixed rent expense                         | \$ 23.7               | \$ 22.6               | \$ 20.5               |
| Variable rent expense                      | 3.8                   | 3.6                   | 3.4                   |
| <b>Finance lease cost:</b>                 |                       |                       |                       |
| Amortization of ROU assets                 | 2.5                   | 2.4                   | 2.2                   |
| Interest expense                           | 2.0                   | 2.1                   | 2.0                   |
| Short-term lease cost                      | 0.2                   | 0.2                   | 0.3                   |
| Sublease income                            | <u>(1.3)</u>          | <u>(1.1)</u>          | <u>(1.2)</u>          |
| <b>Net lease cost</b>                      | <b><u>\$ 30.9</u></b> | <b><u>\$ 29.8</u></b> | <b><u>\$ 27.2</u></b> |
| <br><b>Lease cost - Cost of sales</b>      |                       |                       |                       |
| Lease cost - SG&A                          | <u>4.2</u>            | <u>4.0</u>            | <u>4.1</u>            |
| Lease cost - Depreciation and amortization | <u>22.2</u>           | <u>21.3</u>           | <u>18.9</u>           |
| Lease cost - Interest expense              | <u>2.5</u>            | <u>2.4</u>            | <u>2.2</u>            |
| <b>Net lease cost</b>                      | <b><u>\$ 30.9</u></b> | <b><u>\$ 29.8</u></b> | <b><u>\$ 27.2</u></b> |

Amounts recognized as right-of-use assets related to finance leases are included in fixed assets, net in the accompanying statement of financial position, while related lease liabilities are included in Current portion of long-term debt and Long-term debt. As of December 31, 20X9 and 20X8, right-of-use assets and lease liabilities related to finance leases were as follows:

|                                   | 20x9    | 20x8    |
|-----------------------------------|---------|---------|
| Finance lease ROU assets          | \$ 17.6 | \$ 17.0 |
| <b>Finance lease liabilities:</b> |         |         |
| Current portion of long-term debt | 2.2     | 2.2     |
| Long-term debt                    | 15.3    | 15.1    |

During the years ended December 31, 20x9, 20x8 and 20x7, we had the following cash and non-cash activities associated with our leases:

|  | 20x9    | 20x8    | 20x7    |
|--|---------|---------|---------|
| <b>Cash paid for amounts included in the measurement of lease liabilities:</b> |         |         |         |
| Operating cash flows from operating leases                                     | \$ 26.0 | \$ 25.7 | \$ 24.8 |
| Operating cash flows from finance leases                                       | 2.0     | 2.1     | 2.0     |
| Financing cash flows from finance leases                                       | 2.0     | 1.9     | 1.9     |
| <b>Non-cash investing and financing activities:</b>                            |         |         |         |
| Additions to ROU assets obtained from:   |         |         |         |
| New operating lease liabilities  | \$ 18.7 | \$ 20.3 | \$ 16.2 |
| New finance lease liabilities  | —       | 3.4     | —       |

The future payments due under operating and finance leases as of December 31, 20x9 is as follows:

|                              | Operating      | Finance        |
|------------------------------|----------------|----------------|
| Due in 20x0                  | \$ 22.6        | \$ 2.2         |
| 20x1                         | 23.9           | 3.8            |
| 20x2                         | 24.7           | 3.6            |
| 20x3                         | 25.3           | 3.6            |
| 20x4                         | 24.0           | 3.6            |
| All years thereafter         | <u>8.3</u>     | <u>2.1</u>     |
|                              | 128.8          | 18.9           |
| Less effects of discounting  | <u>(35.9)</u>  | <u>(3.6)</u>   |
| Lease liabilities recognized | <u>\$ 92.9</u> | <u>\$ 15.3</u> |

As of December 31, 20x9 and 20x8, the weighted-average remaining lease term for our operating leases is 4.8 years and 4.9 years, respectively, while the weighted-average remaining lease term for our finance leases is 5.3 years and 5.6 years, respectively.

Because we generally do not have access to the rate implicit in the lease, we utilize our incremental borrowing rate as the discount rate. The weighted average discount rate associated with operating leases as of December 31, 20x9 and 20x8 is 4.2% and 4.0%, respectively, while the weighted-average discount rate associated with finance leases is 3.9% and 3.8%, respectively.

The incremental borrowing rate is the rate of interest that we 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. In determining that rate, the Company considers prevailing economic conditions at the commencement date and factors such as company-specific credit risk, term of the lease and options, and the effect of collateralization based on the nature and quality of the underlying asset.

### 8.3.3 Lessor Disclosure Requirements

Considering the disclosure objective previously discussed, and to help entities achieve that objective, ASC 842 requires that a lessor disclose quantitative and qualitative information about:

- ▶ Its leases,
- ▶ The significant judgments made in applying ASC 842, and
- ▶ The amounts recognized in the financial statements for those leases.

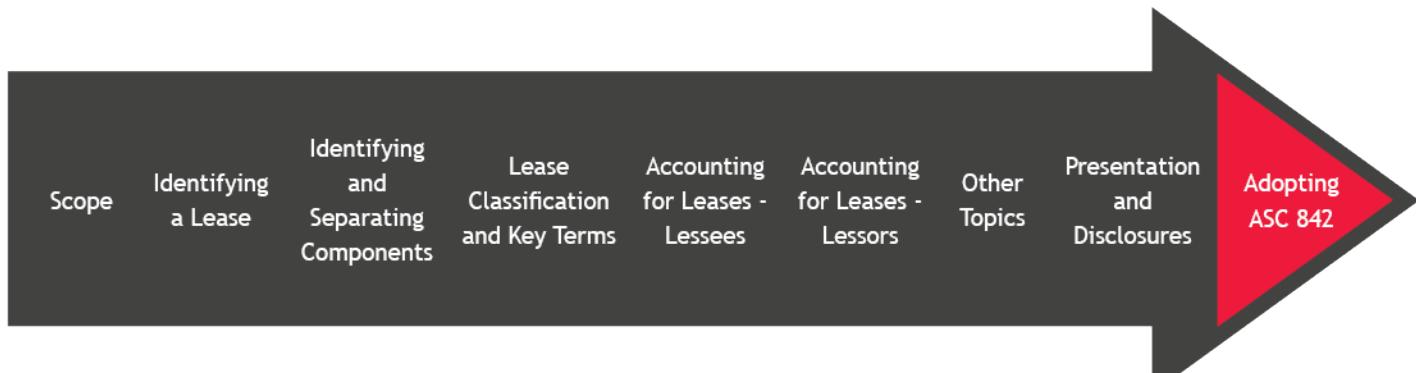
The following table summarizes those disclosure requirements:

| LESSOR DISCLOSURE REQUIREMENTS |  |
|--------------------------------|--|
| Qualitative Disclosures        | <ul style="list-style-type: none"> <li>▶ Information about the nature of its leases, including           <ul style="list-style-type: none"> <li>• A general description of those leases</li> <li>• The basis and terms and conditions on which variable lease payments are determined</li> <li>• The existence and terms and conditions of options to extend or terminate the lease</li> <li>• The existence and terms and conditions of options for a lessee to purchase the underlying asset</li> </ul> </li> <li>▶ Information about significant assumptions and judgments made, including:           <ul style="list-style-type: none"> <li>• The determination of whether a contract contains a lease</li> <li>• The allocation of consideration in a contract between lease and nonlease components (unless a lessor elects the practical expedient in paragraph 842-10-15-42A and all nonlease components in the contract qualify for that practical expedient)</li> <li>• The determination of the amount the lessor expects to derive from the underlying asset following the end of the lease term</li> </ul> </li> <li>▶ Information about how the lessor manages its risk associated with the residual value of its leased assets           <ul style="list-style-type: none"> <li>• Risk management strategy for residual assets</li> <li>• Carrying amount of residual assets covered by residual value guarantees</li> <li>• Any other means by which the lessor reduces its residual asset risk, for example buyback agreements and variable lease payments for use in excess of specified limits</li> </ul> </li> </ul> |
| Quantitative Disclosures       | <ul style="list-style-type: none"> <li>▶ For each annual <i>and interim</i> reporting period, disclose <i>in a tabular format</i>:           <ul style="list-style-type: none"> <li>• Sales-type leases and direct financing leases:               <ul style="list-style-type: none"> <li>• Profit or loss recognized at the commencement date (disclosed on a gross or net basis as discussed in the Presentation section above)</li> <li>• Interest income (either in aggregate or separated by components of the net investment in the lease)</li> <li>• Operating leases: Lease income relating to lease payments</li> <li>• Lease income relating to variable lease payments not included in the measurement of the lease receivable</li> </ul> </li> <li>▶ Disclose the components of the lessor's aggregate net investment in sales-type and direct financing leases (that is, the carrying amount of lease receivables, unguaranteed residual assets, and any deferred selling profit on direct financing leases)</li> <li>▶ Sales-Type and Direct Financing Leases               <ul style="list-style-type: none"> <li>• Explain significant changes in the balance of unguaranteed residual assets and deferred selling profit on direct financing leases</li> </ul> </li> </ul> </li> </ul>  |

|  | LESSOR DISCLOSURE REQUIREMENTS  |
|--|---|
| Policy<br>Elections and<br>Practical<br>Expedients | <ul style="list-style-type: none"> <li>Disclose maturity analysis (commonly referred to as the 5-year table) of undiscounted lease receivables, with a reconciliation of undiscounted cash flows to lease receivables</li> </ul> <p>► Operating Leases</p> <ul style="list-style-type: none"> <li>Disclose maturity analysis (commonly referred to as the 5-year table) of undiscounted lease payments to be received. The maturity analysis for operating leases must be presented separately from the maturity analysis for sales-type and direct financing leases</li> <li>Provide disclosures required by ASC 360 on property, plant, and equipment separately for underlying assets under operating leases from owned assets</li> </ul>  |
| Related Party<br>Leases                            | <p>► An entity that elects the practical expedient to not separate nonlease components from associated lease components (including an entity that accounts for the combined component entirely in ASC 606 on revenue from contracts with customers) should disclose the following by class of underlying asset:</p> <ul style="list-style-type: none"> <li>Accounting policy election and the class or classes of underlying assets for which it has elected to apply the practical expedient</li> <li>The nature of: <ul style="list-style-type: none"> <li>The lease components and nonlease components combined as a result of applying the practical expedient</li> <li>The nonlease components, if any, that are accounted for separately from the combined component because they do not qualify for the practical expedient</li> </ul> </li> <li>The topic the entity uses to account for the combined component (ASC 842 or ASC 606)</li> </ul> <p>► A lessor that elects to exclude from the consideration in the contract and from variable payments not included in the consideration in the contract all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific lease revenue producing transaction and collected by the lessor from the lessee shall disclose its election and comply with the disclosure requirements in ASC 235-10-50-1 through 50-6</p> |
| Sale and<br>Leaseback<br>Transactions              | <p>► Disclose any lease transactions between related parties in accordance with ASC 850 on related party disclosures</p> <p>► The buyer-lessor provides the disclosures applicable to lessors for the leaseback</p>   |
| Leveraged<br>Leases                                | <p>► Although ASC 842 removed leveraged lease accounting, leases that met the definition of a leveraged lease under ASC 840 that commenced before ASC 842's effective date are grandfathered in. As such, entities that continue to have leveraged leases must continue to provide disclosures as required by ASC 842-50, which carries forward existing guidance from ASC 840.</p>   |



# CHAPTER 9 – ADOPTING ASC 842



## 9.1 OVERVIEW

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*, to increase transparency and comparability among entities by requiring:

- ▶ Lessees to recognize leases on balance sheet, and
- ▶ Lessees and lessors to provide more information about their leasing arrangements so that users can better assess the amount, timing, and uncertainty of cash flows from leases.

Under its core principle, a lessee recognizes a right-of-use asset and a lease liability on the balance sheet for most leases. The pattern of expense recognition in the income statement depends on a lease's classification. Lessor accounting remains largely consistent with previous U.S. GAAP but was updated for consistency with the new lessee accounting model and with ASC 606 on revenue from contracts with customers.

ASC 842 was effective for public business entities and certain other entities for fiscal years beginning after December 15, 2018 (January 1, 2019 for calendar year-end public companies), and for interim periods within those fiscal years. For other entities, ASC 842 is now effective for fiscal years beginning after December 15, 2021 and interim periods beginning the following year considering deferrals in effective date the FASB provided to those entities. Early adoption is permitted for all entities.

ASC 842 provides for two transition methods, to which we refer in this Chapter as the modified retrospective approach and the transition alternative. These methods are discussed in detail throughout this Chapter. Regardless of the transition method elected, ASC 842 initially applies to **all** existing leases. Generally, one key objective the FASB had in mind when developing the transition provisions was to allow entities to “run-off” the accounting for their existing leases, with the exception for lessees to recognize their existing operating leases on balance sheet. The run-off approach means that, for example, the initial measurement of existing operating leases by lessees is based on the **minimum rental payments**, as the entity applied it under ASC 840, and for an existing capital lease that is classified as a finance lease under ASC 842, the initial amount reported under ASC 842 is the carrying amount of the capital lease asset and obligation under ASC 840. This also means that, when leases are initially reported using ASC 840 data (minimum rental payments) or carrying amounts, the entity will not reallocate the consideration in the contract if the contract includes nonlease elements (components). However, this run-off approach ceases, and the lease is accounted for under ASC 842, if the lease is modified on or after ASC 842’s effective date and that modification is not accounted for as a separate contract and, for a lessee, if it is required to remeasure the lease payments and the lease liability.

At first, transition to the new leasing standard may seem relatively straight-forward. However, applying the transition requirements can be complex with important nuances that should be considered. After issuing ASU 2016-02, the FASB also issued several additional ASUs that affect certain aspects of transition. Both the FASB and SEC staffs have also on a number of occasions provided interpretive views about specific aspects of the new standard. Accordingly, having a

clear understanding of the transition provisions as amended, and as interpreted, will be key to successfully adopt ASC 842.

This Chapter summarizes the transition requirements of the new standard. It includes insights into certain aspects of the transition requirements and practical examples to assist entities in their implementation of ASC 842. As the icon at the beginning of this Chapter suggests, implementing ASC 842 typically will require cross-functional teamwork.

As entities ready themselves to adopt ASC 842 and obtain an understanding of the transition requirements, they should consider the new processes (or updates to existing processes) and controls they need for a robust adoption, implementation, and ongoing application of the new standard. Entities should consider the following as they adopt ASC 842:



#### Determine System Needs

Many entities that adopted ASC 842 found that they needed to implement software solutions. Unless an entity has a very low number of leases, a software solution may result in a more efficient application of ASC 842 considering its requirements, from initial recognition through ongoing accounting and reporting, including remeasurement of leases on balance sheet for specific events, and the number of disclosures to provide.



#### Know the Lease Population

One of the key challenges in adopting the new standard is ensuring that the lease population is complete, including leases for which payments are fully variable and embedded leases. There are usual suspects, of course, like real estate lease contracts, which are relatively easy to identify and generally are already tracked. But an entity's contracts are not always labeled as "leases." Leases may be embedded in other contracts such as service contracts, IT contracts, and transportation contracts, to name just a few.

If a contract includes the right to use an asset (i.e., a lease), it should be tracked and accounted for as part of adopting ASC 842. This is true even if one elects the package of practical expedients, which includes the ability to not reassess existing contracts. Historically, entities may not have thoroughly assessed service contracts for the existence of embedded leases, given the similarities between operating lease accounting and service expense accounting. However, that assessment was technically required under ASC 840, and the package of practical expedients does not grandfather errors.

This completeness assessment will be a critical and potentially time-consuming step. This also typically won't be an accounting department exercise only – it may involve people from various departments across the entity, including procurement, treasury, IT, and legal, and potentially from foreign locations.



#### Assess Efforts Related to Lease Data Input

Another time-consuming step in the implementation process involves gathering the lease data so that lease assets and liabilities are accurately calculated and reported in the financial statements after adoption. As previously noted, many entities have found that they need a software solution in order to manage compliance with the new lease standard. Use of manual processes such as calculating right-of-use asset and lease liability values on Excel spreadsheets may be less efficient.

Regardless of the method chosen, an entity will need to plan for sufficient time to input the data into the relevant system or program for each lease so that each is accurately reported and disclosed.

## 9.2 EFFECTIVE DATES

For calendar-year public business entities (PBEs), certain not-for-profit organizations (NFPs) and certain employee benefit plans (EBPs), ASC 842 took effect in 2019 and interim periods within that year. For other calendar-year entities, ASC 842 was initially required to take effect in 2020, and interim periods in 2021. However, in November 2019, the FASB issued ASU 2019-10 which initially deferred the effective date of ASC 842 by one year. Also, because of the disruption caused by the Coronavirus Disease 2019 (COVID-19), including resource constraints, dislocation, and other priorities that entities faced with the COVID-19 pandemic, the FASB decided to further defer the effective date of ASC 842 by another year for private companies and certain NFPs. The following table summarizes the final effective dates of ASC 842:

| EFFECTIVE DATES  |   |
|--|---|
| <b>Public business entities, NFPs that have issued or are conduit bond obligors for securities traded, listed or quoted on an exchange or over-the-counter market, and EBPs that file or furnish financial statements with or to the U.S. Securities and Exchange Commission (SEC)</b> | <ul style="list-style-type: none"> <li>▶ Except for NFPs discussed below: Fiscal years beginning after December 15, 2018 and interim periods within those fiscal years.</li> <li>▶ NFPs that have not yet issued financial statements or made financial statements available for issuance as of June 3, 2020: Fiscal years beginning after December 15, 2019 and interim periods within those fiscal years.</li> <li>▶ Early application is permitted.</li> </ul> |
| <b>All other entities</b>  | <ul style="list-style-type: none"> <li>▶ Fiscal years beginning after December 15, 2021 and interim periods within fiscal years beginning after December 15, 2022.</li> <li>▶ Early application is permitted.</li> </ul>  |



### SEC STAFF GUIDANCE

At the December 2019 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff announced that it would not object to a public business entity that otherwise would not meet the definition of a public business entity except for a requirement to include or the inclusion of its financial statements or financial information in another entity's filing with the SEC adopting ASC 842 for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021. Those dates were consistent with the effective dates for ASC 842 as amended in ASU 2019-10. Refer to paragraph 842-10-S65-1.

Also, the CAQ SEC Regulations Committee published its July 2020 highlights which noted "Given that the FASB has deferred the effective dates of certain accounting standards in light of COVID-19, the SEC staff will extend its prior relief related to the adoptions of ASC 842 and ASC 606 to entities that meet the definition of a PBE only because their financial statements or financial information is included in other entities' filings with the SEC to satisfy the requirements of Rules 3-05, 3-09 or 4-08(g) of Regulation S-X."



### PRIVATE COMPANY ADOPTION CONSIDERATIONS

With the new effective dates, a calendar year-end private company is required to adopt ASC 842 on January 1, 2022 for its annual financial statements. While the 2022 annual financial statements may not be issued until sometime in 2023, that calendar-year-end private company is required to recognize its operating leases on the balance sheet on January 1, 2022 and from that date to apply ASC 842 and other GAAP requirements to its existing leases and new leases. Private companies should therefore consider those requirements in their implementation plan.

### 9.2.1 Effective Dates of Additional Accounting Standards Updates

As part of its monitoring of ASC 842 implementation by companies, the FASB made a number of amendments to ASC 842 to address stakeholder concerns. The following table summarizes those ASUs and their effective dates, as further amended by FASB's deferral of effective dates in ASU 2020-05. Note that early application generally is also permitted.

| ASU                   | KEY AMENDMENTS  | EFFECTIVE DATES FOR PBEs, CERTAIN NFPs/EBPs  | EFFECTIVE DATES FOR ALL OTHER ENTITIES  |
|-----------------------|---|--|---|
| 2018-01               | ▶ Land easement practical expedient for transition  | ▶ Fiscal years (FYs) and interim periods beginning after 12/15/2018.   | ▶ Fiscal years (FYs) beginning after 12/15/2021 and interim periods beginning after 12/15/2022. |
| 2018-10               | ▶ Various codification improvements   |  |   |
| 2018-11 <sup>15</sup> | ▶ Lessor practical expedient to not separate nonlease components in a lease contract<br>▶ Alternative transition method   | ▶ NFPs that have not yet issued financial statements or made financial statements available for issuance as of 6/3/2020: FYs and interim periods beginning after 12/15/2019. |   |
| 2018-20 <sup>16</sup> | ▶ Lessor accounting policy for sales taxes and other similar taxes<br>▶ Lessor costs paid by lessees directly to third parties<br>▶ Lessor recognition of variable payments in lease contracts with nonlease components |  |   |
| 2019-01               | ▶ Determining fair value of the underlying asset by lessors that are not manufacturers or dealers<br>▶ Presentation by lessor on statement of cash flows for certain leases   | ▶ FYs and interim periods beginning after 12/15/2019.  | ▶ FYs beginning after 12/15/2021 and interim periods after 12/15/2022.                          |
| 2020-04               | ▶ Optional expedient for modifications of lease contracts that reference LIBOR  | ▶ Effective for all entities as of 3/12/2020 through 12/31/2022.   |   |
| 2021-05 <sup>17</sup> | ▶ Accounting by lessors for certain leases with variable lease payments   | ▶ FYs and interim periods beginning after 12/15/2021.  | ▶ FYs beginning after 12/15/2021 and interim periods after 12/15/2022.                          |
| 2021-09 <sup>18</sup> | ▶ Discount rate for lessees that are not public business entities   |  |   |
| 2023-01               | ▶ Accounting for common control arrangements and amortization of leasehold improvements in common control leases  | ▶ FYs and interim periods beginning after 12/15/2023.  | ▶ FYs and interim periods beginning after 12/15/2023.   |

<sup>15</sup> Effective dates presented are for entities that did not adopt ASC 842 by the issuance date of ASU 2018-11. For entities that had adopted ASC 842, refer to paragraph 842-10-65-2 for additional effective date and transition guidance.

<sup>16</sup> Effective dates presented are for entities that did not adopt ASC 842 by the issuance date of ASU 2018-20. For entities that had adopted ASC 842, refer to paragraph 842-10-65-3 for additional effective date and transition guidance.

<sup>17</sup> For entities that had adopted ASC 842 by the issuance date of this ASU, refer to paragraph 842-10-65-5 for additional effective date and transition guidance.

<sup>18</sup> NFPs (including a conduit bond obligor) and EBPs are not *public business entities* (according to the definition in the Master Glossary) and, therefore, are permitted to make the risk-free rate election. Also, for entities that adopted ASC 842 before issuance date of this ASU, refer to paragraph 842-10-65-6 for additional effective date and transition guidance.

## 9.3 TRANSITION METHODS

### 9.3.1 Modified Retrospective Approach

ASU 2016-02 initially included a single transition method with which to adopt ASC 842, which we refer to in this Chapter as the modified retrospective approach. Under that transition method, an entity applies ASC 842 retrospectively to each prior reporting period, subject to specific practical expedients and transition requirements.

An entity that is a lessee must recognize operating leases on balance sheet at the later of:

- ▶ The beginning of the earliest comparative period presented in the financial statements, and
- ▶ The commencement date of the lease.

The later of the two dates above represents the “application date” under this transition method; that is, the date at which the ASC 842 transition requirements are applied to the lease.

The recognition requirement applies to all existing operating leases, including leases that expired before the effective date (adoption date) but subsequent to the application date. However, if a lessee elects the accounting policy related to short-term leases for an asset class, the lessee does not apply the approach discussed in this Chapter to those short-term leases. A short-term lease is a lease that, at the commencement date, has a lease term of 12 months or less and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise. See Chapter 5 for additional guidance on short-term leases. Note that under this transition a lessee should determine whether a lease qualifies as a short-term lease based on the lease term at lease commencement rather than based on the remaining term at the application date. Also, any lease that commences after ASC 842’s effective date is accounted for under ASC 842.

The effect of adopting ASC 842, if any, is recognized as a cumulative effect adjustment to retained earnings at the beginning of the earliest comparative period presented.

An entity (lessee or lessor) must also provide the new and enhanced disclosures under ASC 842 in all periods presented, including the prior periods. See Chapter 8 for additional guidance.

### 9.3.2 Transition Alternative

In July 2018, the FASB issued ASU 2018-11, *Leases (Topic 842) - Targeted Improvements*, which provides entities with an additional (and optional) transition method with which to adopt ASC 842, which we refer to in this Chapter as the transition alternative. Under this transition method, an entity initially applies ASC 842 to all leases existing at the effective date (adoption date) and recognizes a cumulative effect adjustment to the opening balance of retained earnings, if any, as of that date. The adoption date therefore represents the “application date” under this transition method.

As discussed above, if a lessee elects the accounting policy related to short-term leases for an asset class, the lessee does not apply the approach discussed in this Chapter to those short-term leases. Note that under this transition alternative, a lessee should determine whether a lease qualifies as a short-term lease based on the lease term at lease commencement rather than based on the remaining term at the adoption date. Also, any lease that commences after ASC 842’s effective date is accounted for under ASC 842.

The comparative periods presented in the financial statements remain under the legacy leases guidance (ASC 840). If an entity elects this transition alternative, it is required to provide the ASC 840 disclosures for all prior periods presented that remain under the legacy leases guidance. This transition requirement does not change the existing disclosure requirements in ASC 840 (for example, it does not create interim disclosure requirements that entities previously were not required to provide).

The FASB provided this additional transition method to reduce costs and complexity for preparers in implementing ASC 842. Given the significant cost relief provided by this transition alternative, we expect many entities will adopt ASC 842 using that transition method rather than the modified retrospective approach.

### 9.3.3 What's the Difference Between the Two Transition Methods?

To illustrate the main differences between the two transition methods, assume a calendar year-end public business entity that adopted ASC 842 on January 1, 2019 and that presents three years of income statements (current period and two comparative periods). In that situation, the beginning of the earliest comparative period presented for that entity is January 1, 2017, and its adoption date is January 1, 2019. For that entity, the main differences between the two transition methods are summarized in the following table:

|  | MODIFIED RETROSPECTIVE APPROACH   | TRANSITION ALTERNATIVE  |
|--|---|---|
| Application Date   | <p>The later of (1) January 1, 2017 and (2) lease commencement date. For example:</p> <ul style="list-style-type: none"> <li>▶ For a lease that commenced before January 1, 2017, the application date for that lease is January 1, 2017. Therefore, the entity applies the ASC 842 transition requirements to that lease on January 1, 2017.</li> <li>▶ For a lease that commenced after January 1, 2017 such as June 15, 2017, the application date is its lease commencement date of June 15, 2017.</li> </ul> | <p>January 1, 2019 for all existing leases. Therefore, the entity applies the ASC 842 transition requirements to all of its existing leases on January 1, 2019.</p>   |
| Recognition  | <p>Recognize all existing leases at the application date (the “later of date” above).</p> <p>Record a cumulative effect adjustment to retained earnings, if any, as of January 1, 2017 and adjust the income statement for prior periods as necessary (e.g., write off costs incurred after January 1, 2017 that do not meet the definition of initial direct costs under ASC 842, if applicable - see package of practical expedients discussion below).</p>   | <p>Recognize all existing leases as of January 1, 2019.</p> <p>Record a cumulative effect adjustment to retained earnings, if any, as of January 1, 2019 for any effects of adoption (e.g., write off of unamortized initial direct costs under ASC 840 that do not meet the definition of initial direct costs under ASC 842, if applicable - see package of practical expedients discussion below).</p> |
| Discount Rate for Operating Leases (Lessees)                 | Determined at the application date (i.e., the “later of date” discussed above).   | Determined as of January 1, 2019 for all existing operating leases.   |
| Operating Leases Denominated in a Foreign Currency (Lessees) | Apply ASC 830 for leases denominated in a foreign currency. This means that foreign currency exchange rates should be tracked, and transaction gains and losses recognized, during the comparative periods for those operating leases now recognized on balance sheet.  | <p>Comparative periods are not affected since they remain under ASC 840 (i.e., operating leases are not recognized on balance sheet).</p> <p>Starting on January 1, 2019 (when all existing operating leases are recognized on balance sheet), apply ASC 830.</p>   |
| Disclosures  | Provide all ASC 842 disclosures for the current and all comparative periods.  | Provide ASC 842 disclosures for the current period and provide ASC 840 disclosures for the comparative periods.   |

### 9.3.4 What Stays the Same Between the Two Transition Methods?

As illustrated in the table above, the transition alternative generally changes *when* an entity initially applies ASC 842 (e.g., when a lessee recognizes operating leases on balance sheet) but it does not change *how* an entity initially

applies it. For example, the guidance about how an entity initially measures existing operating leases is the same regardless of whether the modified transition approach or the transition alternative is elected.

#### EXAMPLE 1 - TRANSITION APPROACH AND APPLICATION DATE

##### FACTS

- ▶ Susie's Stitch-n-Sew (Susie's) entered into a five-year noncancelable arrangement on 1/1/2018 with a mall operator that meets the definition of a lease under ASC 840.
- ▶ Susie's classified the lease as an operating lease.
- ▶ Assume 1/1/2018 is both the inception date and commencement date of the lease.
- ▶ On 1/1/2019, Susie's adopts ASC 842. Susie's initial application of ASC 842 depends on the transition method it elects.

##### SCENARIO 1: Susie's adopts ASC 842 using the transition alternative

- ▶ Susie's recognizes the above operating lease (along with any other existing operating leases) on balance sheet on 1/1/2019 (adoption date), which is Susie's application date under the transition alternative.
- ▶ The prior period balance sheet (i.e., for the year ended 12/31/2018) remains under ASC 840 which means it does not include recognition of an ROU asset or lease liability for the above lease.
- ▶ Susie's is required to provide the ASC 840 disclosures for all prior periods still under ASC 840, which includes the 2018 balance sheet. Therefore, Susie's provides all disclosures required under ASC 840, including the disclosure about future minimum rental payments required as of 12/31/2018 in accordance with paragraph 840-20-50-2. This information will enable users to compare both balance sheets, for example, through constructive capitalization of the 2018 balance sheet using the footnote disclosure of future minimum rental payments remaining at 12/31/2018.
- ▶ Susie's should also provide the ASC 842 disclosures for the period of adoption (i.e., for 2019).

##### SCENARIO 2: Susie's adopts ASC 842 using the modified retrospective approach

- ▶ Susie's recognizes the above operating lease (along with any other existing leases) at the application date, which for this operating lease is 1/1/2018 (i.e., the later of 1/1/2017 if Susie's presented three periods of income statement, and the lease commencement date of 1/1/2018).
- ▶ Susie's should provide the ASC 842 disclosures for all periods presented, including the comparative periods.

## 9.4 TRANSITION DISCLOSURES

### 9.4.1 General Disclosure Considerations

An entity provides transition disclosures required by ASC 250 on accounting changes and error corrections, except for:

- ▶ The requirements in paragraph 250-10-50-1(b)(2) on the effect of the change on income from continuing operations, net income (or other appropriate captions), any other affected financial statement line item, and any affected per-share amounts for the current period and any prior periods retrospectively adjusted, and
- ▶ The requirements in paragraph 250-10-50-3 for the effects discussed above on financial information reported for interim periods.

An entity that elects the transition alternative should provide the transition disclosures in paragraph 250-10-50-1(b)(3) as of the beginning of the period of adoption rather than at the beginning of the earliest period presented.

Also, as discussed later in this Chapter if an entity elects one or more practical expedients, it should disclose that fact.

### 9.4.2 Public Company Disclosure Considerations

In periods prior to ASC 842's adoption, registrants are required to make disclosures under the SEC's Staff Accounting Bulletin No. 74 (codified in SAB Topic 11.M), *Disclosure Of The Impact That Recently Issued Accounting Standards Will Have On The Financial Statements Of The Registrant When Adopted In A Future Period* ("SAB 74"). SAB 74 requires that when a recently issued accounting standard has not yet been adopted, a registrant disclose the potential effects of the future adoption in its interim and annual SEC filings. SAB 74 disclosures should be both qualitative and quantitative. According to Center for Audit Quality (CAQ) Alert 2017-03, *SAB Topic 11.M - A Focus on Disclosures for New Accounting Standards*, the SEC staff expects that SAB 74 disclosures will become more robust and quantitative as the new accounting standard's effective date approaches. As such, the following types of SAB 74 disclosures are expected in a registrant's financial statements in the periods before new accounting standards are effective:

- ▶ *A comparison of accounting policies.* Registrants should compare their current accounting policies to the expected accounting policies under the new accounting standard(s).
- ▶ *Status of implementation.* The status of the process should be disclosed, including significant implementation matters not yet addressed or if the process is lagging.
- ▶ *Consideration of the effect of new footnote disclosure requirements in addition to the effect on the balance sheet and income statement.* A new accounting standard may not be expected to materially affect the primary financial statements; however, it may require new significant disclosures that require significant judgments.
- ▶ *Disclosure of the quantitative impact of the new accounting standard if it can be reasonably estimated, or disclosure that the expected financial statement impact of the new accounting standard cannot be reasonably estimated.*
- ▶ *Qualitative disclosures.* When the expected financial statement impact is not yet known by a registrant, a qualitative description of the effect of the new accounting standard on the registrant's accounting policies should be disclosed.

## 9.5 TRANSITION PRACTICAL EXPEDIENTS

The FASB provided several transition practical expedients to reduce an entity's cost of adopting ASC 842. The package of practical expedients and the practical expedient to use hindsight were provided in ASU 2016-02. Another practical expedient was added subsequently to address specific concerns raised by certain stakeholders relating to diversity in practice that existed in the accounting for land easements and the costs associated with implementing ASC 842 to those arrangements.

### 9.5.1 Package of Practical Expedients

ASC 842 provides three practical expedients that, if elected must be applied as a package consistently to all of an entity's leases (as a lessee and as a lessor) that commenced before the effective date.

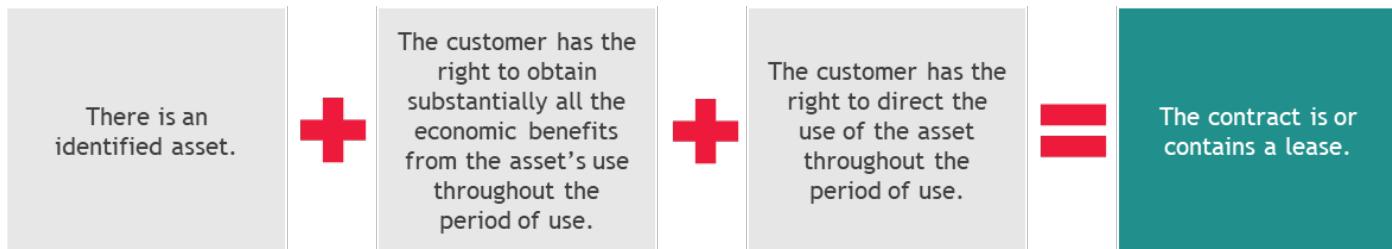


Considering the significant benefits associated with the package of practical expedients, we expect that most entities will elect it. Nonetheless, there are important considerations which we will discuss separately for each practical expedient included in this package.

#### 9.5.1.1 Not Reassessing Expired or Existing Contracts

ASC 842 is generally consistent with prior guidance and limits its application to leases of property, plant or equipment. A lease is defined as “a contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration.”

A contract is or contains a lease under ASC 842 when:



While the definitions of a lease under ASC 840 and ASC 842 are similar, there are nuances that could result in a different conclusion. For example, under ASC 840 a customer could have the right to control the use of an asset solely based on obtaining substantially all the output from that asset, assuming the contract is priced in a certain way (e.g., some power purchase agreements). However, those same arrangements may not be leases under ASC 842 if the customer does not direct the use of the underlying asset (i.e., power criterion). See Chapter 2 for additional guidance.

However, if an entity elects the package of practical expedients, it does not reevaluate its existing contracts under ASC 842. Instead, the entity carries forward its previous conclusions reached under ASC 840 when adopting ASC 842. For example, if an entity evaluated a contract under ASC 840 and correctly determined that the contract contained a lease, the entity carries forward that conclusion when applying the transition requirements of ASC 842.

### BDO INSIGHTS – ERRORS AND OMISSIONS OF ASSESSMENT UNDER ASC 840 NOT GRANDFATHERED

The FASB provided this practical expedient because the Board expected that most leases under ASC 840 would be leases under ASC 842 and therefore the costs of applying the new definition of a lease to all existing contracts generally would exceed the related benefits. However, electing the package of practical expedients does not grandfather errors or omissions of assessment. For example, if the entity did not previously evaluate a contract under ASC 840 (e.g., a potential embedded lease in a service contract) and that contract would meet the definition of a lease, or if it evaluated a contract but reached an incorrect accounting conclusion, those errors are not grandfathered by the election of the package of practical expedients. In those situations, if the entity still plans on electing the package of practical expedients, it must evaluate those contracts under ASC 840 (i.e., not under ASC 842) to be able to benefit from the package of practical expedients.

#### 9.5.1.2 Not Reassessing Lease Classification

Based on the lease classification guidance in ASC 842 (as amended by ASU 2021-05):

If one or more of the following conditions are met:

|   |   |  |  |   |
|---|---|--|--|---|
| The lease transfers ownership of the underlying asset to the lessee by the end of the lease term. | The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise. | The lease term is for the major part of the remaining economic life of the underlying asset. (Exception exists for leases that commence at or near the end of the economic life of the underlying asset) | The present value of the sum of lease payments and any residual value guaranteed by the lessee not reflected in lease payments equals or exceeds substantially all of the underlying asset's fair value. | 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 lessee classifies the lease as a finance lease; and the lessor classifies the lease as a sales-type lease (unless there are variable lease payments not based on an index or a rate and that would result in the lessor recognizing a selling loss).

When none of the above criteria are met, a lessee classifies the lease as an operating lease, and a lessor classifies the lease as either an operating lease or a direct financing lease based on additional requirements. See Chapter 4 for additional guidance. The following applies in transition depending on whether the entity elects the package of practical expedients:

| ENTITY ELECTS PACKAGE  | ENTITY DOES NOT ELECT PACKAGE   |
|--|---|
| The entity does not reassess classification of its expired or existing leases under ASC 842 but carries forward its previous conclusions reached under ASC 840 when adopting ASC 842. For example, if an entity determined that a lease was classified as an operating lease under ASC 840, the entity carries forward that classification when applying the transition requirements of ASC 842. | The entity must reassess lease classification under ASC 842 at the later of the commencement date of the lease or the most recent lease modification that required the entity to reassess lease classification. If the classification changes, there are specific recognition and measurement requirements that generally result in the entity revaluing the lease. |

### BDO INSIGHTS – LEASE CLASSIFICATION NOT EXPECTED TO CHANGE SIGNIFICANTLY

The FASB provided this practical expedient as it concluded that the costs of applying the new lease classification tests to all existing leases generally would exceed the related benefits (for example, the Board expected that most operating leases under ASC 840 would also be classified as operating leases under ASC 842). However, there are situations in which lease classification could change between ASC 840 and ASC 842 (for example, there is no longer prescriptive lease classification guidance for real estate under ASC 842), and entities impacted may want to consider the information ultimately provided to their users in determining whether to elect the package of practical expedients or not.

### 9.5.1.3 Not Reassessing Initial Direct Costs

Under ASC 842, initial direct costs are defined as the incremental costs of a lease that would not have been incurred if the lease had not been obtained. This means that lease commissions and payments made to an existing tenant to incentivize that tenant to terminate its lease meet the definition of initial direct costs under ASC 842. But other costs, such as costs to negotiate or arrange the lease that would have been incurred regardless of whether the lease was obtained are not initial direct costs. Examples of such costs include fixed employee salaries, general overheads, costs incurred by the lessor to solicit potential lessees through advertising, and other costs related to activities that occur before a lease is obtained (such as costs to negotiate the lease, to obtain legal or tax advice, or to evaluate a potential lessee's financial condition). This is because the potential lessee could have walked away at the last minute and these costs would still be due to attorneys, employees, etc. See Chapter 4 for additional guidance.

The following applies in transition depending on whether the entity elects the package of practical expedients:

| ENTITY ELECTS PACKAGE  | ENTITY DOES NOT ELECT PACKAGE   |
|--|---|
| The entity does not reassess capitalized initial direct costs of existing leases under ASC 842. Instead, the entity includes existing unamortized initial direct costs under ASC 840 in the initial measurement of the lease. For example, assume an entity (lessee) deferred initial direct costs related to an operating lease under ASC 840, and the unamortized balance of such initial direct costs is \$5,000 at the application date. If the entity elects the package of practical expedients, the entity includes that \$5,000 balance in the initial measurement of the right-of-use asset for that operating lease. | The entity should reassess all existing capitalized initial direct costs under ASC 842.<br>The entity should write off those that do not meet the definition of initial direct costs under ASC 842 as an adjustment to retained earnings, unless the entity elects the modified retrospective approach and the costs were incurred after the beginning of the earliest period presented, in which case those costs should be written off as an adjustment to earnings in the period in which they are incurred. |

#### BDO INSIGHTS – DEFINITION OF INITIAL DIRECT COSTS NARROWER UNDER ASC 842 COMPARED TO ASC 840

The definition of initial direct costs under ASC 842 is substantially narrower than the definition under ASC 840 and aligns with the definition of incremental costs to obtain a contract under ASC 340-40. This may represent a significant change for certain entities; for example, those with active leasing programs that currently capitalize external legal and other consulting fees, internal legal fees and costs associated with an internal leasing department. Under ASC 842, those costs will generally be expensed as incurred.

An entity expecting to be significantly impacted by this change in definition should consider the aggregate effect of electing the package of practical expedients before reaching a decision. For example, if an entity capitalized a significant amount of initial direct costs under ASC 840 for existing leases and expects to capitalize a significantly lower amount for new leases, expenses on the income statement for the periods under ASC 842 will reflect both (a) amounts of lease origination costs for new leases incurred during the period that do not meet the definition of initial direct costs under ASC 842, and (b) amortization of initial direct costs previously capitalized under ASC 840.

However, not electing the package of practical expedients means the entity will not be able to benefit from the other two expedients included in the package (not reassessing whether a contract is or contains a lease, and not reassessing lease classification). While the outcome of these two reassessments may be expected to be substantially the same as under ASC 840, the time and effort to perform and document the reassessment may be significant. Accordingly, an entity should consider its specific facts and circumstances in determining whether to elect the package of practical expedients or not (e.g., usefulness of information in the financial statements, time needed to reassess existing contracts, etc.).

**EXAMPLE 2 - TRANSITION APPROACH AND PACKAGE OF PRACTICAL EXPEDIENTS****FACTS**

- ▶ In Example 1, we introduced Susie's lease of retail space commencing on 1/1/2018 for a five-year noncancelable period. Also assume that there are three five-year renewal options and the following additional details about Susie's lease.
- ▶ *Payment terms.* Rent payments started on 1/1/2018 and are \$50,000 per month payable in advance plus one percent of sales during the initial five-year term. Base rent increases by 10% in each five-year renewal period (for example, rent is \$55,000 per month for the first renewal period).
- ▶ *Leasehold improvements.* Susie's incurred costs to construct leasehold improvements to customize the space to its brand requirements with an estimated useful life of eight years. The unamortized leasehold improvements balance at the end of the noncancelable period are significant to Susie's.
- ▶ *Initial direct costs.* Susie's incurred initial direct costs of \$22,000, which includes \$15,000 of legal fees for the review and negotiations of the lease, and \$7,000 in broker commissions.
- ▶ There were no modifications to the lease agreement.

**ACCOUNTING UNDER ASC 840**

- ▶ Susie's concluded that the contract was a lease under ASC 840.
- ▶ Susie's determined that the lease term was ten years (the initial five-year term plus one five-year renewal period). This is because the unamortized leasehold improvements at the end of the noncancelable period were significant to Susie's, and therefore Susie's concluded it was reasonably assured to exercise the first renewal option.
- ▶ Susie's determined that the lease was an operating lease and therefore Susie's did not recognize this lease on balance sheet under ASC 840.
- ▶ Susie's recognized straight-line lease expense of \$630,000 during 2018 (the sum of the lease payments over the 10-year lease term, divided by 10), which resulted in an accrued rent balance of \$30,000 as of 12/31/2018 on balance sheet.
- ▶ Unamortized initial direct costs at 12/31/2018 are \$19,800 (\$22,000 / 10 years X 9 years remaining) and are comprised of \$13,500 unamortized legal fees and of \$6,300 unamortized broker commission.
- ▶ In its financial statements for the year ended 12/31/2018, Susie's provided all required ASC 840 disclosures, including disclosure of rental expense with separate amounts for minimum rentals and contingent rent. Susie's also disclosed future minimum rental payments of \$5,700,000 for the above lease (four remaining years at \$50,000 per month plus five years at \$55,000 per month).

**ADOPTION OF ASC 842**

- ▶ On 1/1/2019, Susie's adopts ASC 842.
- ▶ Susie's did not elect the practical expedient to use hindsight.
- ▶ Susie's initial application of ASC 842 depends on which transition method it elects and whether it elects the package of practical expedients.

### SUSIE'S ADOPTS ASC 842 USING THE TRANSITION ALTERNATIVE

Susie's recognizes the above operating lease on balance sheet on 1/1/2019, as illustrated in Example 1.

#### And Elects the Package of Practical Expedients (Which It Must Do for All Its Leases)

Accordingly, Susie's does not reassess:

- ▶ Whether this contract is a lease (i.e., it is a lease for purposes of adopting ASC 842),
- ▶ Lease classification (i.e., it is an operating lease for purposes of adopting ASC 842),
- ▶ Initial direct costs capitalized (i.e., the \$22,000 continue to be capitalized).  
Therefore, the amount of unamortized initial direct costs of \$19,800 at 12/31/2018 is included in the initial measurement of the right-of-use asset on 1/1/2019.

#### And Does Not Elect the Package of Practical Expedients

Accordingly, Susie's reassesses:

- ▶ Whether this contract is a lease. In this case, Susie's concludes the contract is also a lease under ASC 842,
- ▶ Lease classification. In this case, Susie's determines the lease is also classified as an operating lease at 1/1/2018 under ASC 842,
- ▶ Initial direct costs capitalized. In this case, Susie's determines that a portion of initial direct costs (legal fees) capitalized under ASC 840 does not meet the definition of initial direct costs under ASC 842. Therefore, the unamortized portion of these costs (\$13,500 at 12/31/2018) is written off as an adjustment to retained earnings on 1/1/2019. The remaining unamortized portion of initial direct costs (\$6,300 unamortized commission) is added to the initial measurement of the right-of-use asset on 1/1/2019.

### SUSIE'S ADOPTS ASC 842 USING THE MODIFIED RETROSPECTIVE APPROACH

Susie's recognizes the above operating lease on balance sheet on 1/1/2018, as illustrated in Example 1.

#### And Elects the Package of Practical Expedients (Which It Must Do for All Its Leases)

Accordingly, Susie's does not reassess:

- ▶ Whether this contract is a lease (i.e., it is a lease for purposes of adopting ASC 842),
- ▶ Lease classification (i.e., it is an operating lease for purposes of adopting ASC 842),
- ▶ Initial direct costs capitalized (i.e., the \$22,000 continue to be capitalized).  
Therefore, the entire amount of initial direct costs of \$22,000 is included in the initial measurement of the right-of-use asset on 1/1/2018.

#### And Does Not Elect the Package of Practical Expedients

Accordingly, Susie's reassesses:

- ▶ Whether this contract is a lease. In this case, Susie's concludes the contract is also a lease under ASC 842,
- ▶ Lease classification. In this case, Susie's determines the lease is also classified as an operating lease at 1/1/2018 under ASC 842,
- ▶ Initial direct costs capitalized. In this case, Susie's determines that a portion of initial direct costs (legal fees) capitalized under ASC 840 do not meet the definition of initial direct costs under ASC 842. As such, the \$15,000 must be written off as an expense (rather than retained earnings) when incurred because those costs were incurred during a period for which an income statement is presented. The remaining costs (\$7,000 commission) is added to the initial measurement of the right-of-use asset on 1/1/2018.

### 9.5.2 Hindsight Practical Expedient

An entity may use hindsight in determining the lease term (when considering lessee options to renew or terminate and to purchase the underlying asset) and in assessing impairment of right-of-use assets. This expedient:

- ▶ If elected, must be applied by the entity to all of its leases (for example, the entity cannot choose to apply it only to leases under which it is a lessor and not to leases under which it is a lessee),
- ▶ May be elected separately or in conjunction with either or both the package of practical expedients and the land easements practical expedient.

If an entity elects the hindsight practical expedient, the entity performs the reassessment of lease term and purchase options at the adoption date (for example, January 1, 2019 for a calendar year-end public business entity) irrespective of the transition method elected. The entity also should consider all economic factors relevant to that assessment, including those that are contract-based, asset-based, market-based and entity-based consistent with paragraph 842-10-55-26. An entity cannot simply look at renewals or purchase options it knows have been exercised.

#### BDO INSIGHTS – CONSIDERATIONS FOR ELECTING HINDSIGHT PRACTICAL EXPEDIENT

The hindsight practical expedient was initially intended to provide relief when the modified retrospective approach was the only transition method available. Specifically, it was intended to allow an entity to avoid reassessing lease term and impairment of right-of-use assets during each of the prior periods presented. However, electing the hindsight practical expedient may be time consuming depending on the volume of leases that an entity has and may result in additional complexity in applying the transition requirements (for example, if the entity elects the package of practical expedients and therefore retains the same lease classification, but the lease term changes based on the use of hindsight). Also, the hindsight assessment should be performed at the date of adoption (for example, January 1, 2022 for a calendar year-end private company). It cannot be performed at an earlier date without adjusting the evaluation for significant changes in economic factors between the date of evaluation and date of adoption. Considering the level of work generally needed for this practical expedient, and the lack of benefits when a company elects the transition alternative, many entities have not or do not plan to elect it.

### 9.5.3 Land Easements Practical Expedient

Land easements (also commonly referred to as rights of way) represent the right to use, access, or cross another entity's land for a specified purpose. Easements are used in various industries, such as in the energy, utilities, transportation and telecom industries. For example:

- ▶ A midstream energy company may acquire a land easement for the right to pass a pipeline over, under, or through an existing area of land while allowing the landowner continued use of the land for other purposes (farming, hunting, etc.) if the landowner does not interfere with the rights of the midstream energy entity.
- ▶ An electric utility might acquire a series of contiguous easements so that it can construct and maintain its electric transmission system on land owned by others.

Terms of land easements can vary greatly between agreements. For example, a land easement may be perpetual or term based, may provide for exclusive or nonexclusive use of the land, and may be prepaid or paid over a defined term. The grantor (landowner) also may retain rights associated with access and use of the land area, or it may be restricted in its ability to access and use the land area.

Diversity has historically existed in U.S. GAAP in the accounting for land easements before the introduction of ASC 842. For example:

- ▶ Some entities have accounted for their land easements as intangible assets based on the guidance in Example 10 of ASC 350-30, *Intangibles—Goodwill and Other—General Intangibles Other than Goodwill*, which refers to land easements in that example as intangible assets.
- ▶ Some entities have applied ASC 360 and considered the prepaid land easement as a cost to bring property, plant or equipment (for example, a pipeline) to the condition and location necessary for its intended use.
- ▶ Some entities have applied ASC 840 (for example, a cell tower company entering into a land easement for the right to erect a communication tower).

Because of that diversity, in January 2018, the FASB issued ASU 2018-01, *Land Easement Practical Expedient for Transition to Topic 842*, to clarify that land easements are in the scope of ASC 842. However, considering the existing diversity in accounting, ASU 2018-01 allows entities that previously did not account for land easements as leases under ASC 840 to elect a transition practical expedient to not assess those land easements under ASC 842 when adopting the new standard. This approach is intended to reduce the cost and complexity associated with assessing whether existing and expired land easements meet the definition of a lease for entities transitioning to ASC 842. Instead, entities will continue to account for those land easements under other GAAP unless the land easement is modified on or after ASC 842's adoption date. An entity that currently accounts for land easements as leases under ASC 840 cannot elect this practical expedient for those easements.

An entity must apply this expedient consistently to all its existing and expired land easements that were not accounted for as leases under ASC 840, and it may be elected separately or in conjunction with either or both the package of practical expedients and the hindsight practical expedient.

Also, because the Board clarified in ASU 2018-01 that land easements are in the scope of ASC 842, once an entity adopts the new lease standard, it must apply that guidance prospectively to all new or modified land easements to determine whether those arrangements meet the definition of a lease under ASC 842.

#### BDO INSIGHTS – PRACTICAL EXPEDIENT PROVIDED FOR COST-BENEFIT REASONS

Through outreach with stakeholders in industries most involved with land easements, the FASB learned that many land easements are perpetual (and therefore would not meet the definition of a lease under ASC 842 because they are not “for a period of time”) and that many land easements are prepaid (and therefore already recognized on balance sheet). The Board therefore did not want entities to incur significant time and effort (considering the volume of land easements and age of those agreements) to evaluate them under ASC 842, especially considering that adoption of ASC 842 was generally not expected to have a material impact for these existing land easements.

While diversity in practice in accounting for land easements exists before ASC 842, it generally would be inappropriate for an entity to change its accounting policy prior to adopting ASC 842 from accounting for those as leases under ASC 840 to accounting for those under ASC 350 or ASC 360.

#### EXAMPLE 3 - LAND EASEMENTS IN TRANSITION

Electric Company obtained a series of easements years before its adoption of ASC 842. The easements were obtained so that Electric Company could install poles to which its power lines would be attached. In addition to installing its poles, Electric Company has the right to access the poles via a corridor leading from the nearest road to the pole. Electric Company will make payments over time under the easement agreement in return for long-term access rights. Electric Company historically accounted for those land easements along with its poles as property, plant and equipment under ASC 360.

Because Electric Company did not account for those land easements as leases under ASC 840, it can elect the land easement practical expedient. This means that Electric Company will continue to account for those land easements under ASC 360 unless the agreement is modified on or after ASC 842's adoption date, in which case Electric Company will need to assess whether those easements meet the definition of a lease under ASC 842. If elected, the practical expedient must be applied to all of Electric Company's land easements not accounted for as leases under ASC 840.

Alternatively, if Electric Company does not elect the land easements practical expedient, it should evaluate all of its existing land easements when adopting the new standard to determine whether those easements meet the definition of a lease under ASC 842.

### 9.5.4 Common Control Arrangements

Private company stakeholders raised concerns about ASC 842 application to common control arrangements (such as arrangements between sister entities controlled by a common owner). Concerns included determining whether a common control arrangement is or contains a lease based on the legally enforceable terms and conditions. In response to those concerns, the FASB issued ASU 2023-01, Leases (Topic 842): *Common Control Arrangements*.

ASU 2023-01 provides nonpublic entities<sup>19</sup> a practical expedient to use the written terms and conditions of a common control arrangement to determine whether a lease exists and, if so, to classify and account for that lease. Under the practical expedient, an entity assesses whether the written terms and conditions convey the **practical right** (rather than an enforceable right) to control the use of an identified asset for a period of time in exchange for consideration to determine whether a lease exists. If a lease exists, the entity classifies and accounts for the lease based on those written terms and conditions. The practical expedient may be applied on an arrangement-by-arrangement basis.

If no written terms and conditions exist, the entity cannot apply the practical expedient and it must use the enforceable rights and obligations to apply ASC 842 to the common control arrangement, like any arrangement between unrelated parties or related parties not under common control.

However, as part of transition, an entity may document the unwritten terms and conditions of existing common control arrangements. Such documentation must be completed before the entity's first interim or annual financial statements in which ASU 2023-01 is first applied are available to be issued. See Section 2.5 for further discussion about the practical expedient and Section 9.2.1 for effective dates.

#### BDO INSIGHTS - PRACTICAL EXPEDIENT ADOPTION CONSIDERATIONS

When using the transition relief described above, private entities should document the terms and conditions of common control arrangements that were in effect and considered in applying ASC 840, *Leases*. Any revision to those terms and conditions that change the scope of the lease or the consideration for the lease should be accounted for as modifications (at the effective date of such modification), rather than considered part of adoption.

ASU 2023-01 is applied using the following transition methods:

| STATUS OF ASC 842 ADOPTION                 | TRANSITION METHOD  |
|--|--|
| Entities that have not yet adopted ASC 842 | Same transition method elected to apply ASC 842 (see Section 9.3). Also, the practical expedient can be elected separately from other transition practical expedients discussed in this section for those common control arrangements.   |
| Entities that have already adopted ASC 842 | <p>Either:</p> <ul style="list-style-type: none"> <li>▶ Prospectively to arrangements that commence or are modified on or after the date that the entity first applies the practical expedient</li> <li>▶ Retrospectively to the beginning of the period when the entity first applied ASC 842 for arrangements that exist at the date of adoption of the practical expedient           <ul style="list-style-type: none"> <li>• The practical expedient does not apply to common control arrangements no longer in place at the adoption date of ASU 2023-01</li> </ul> </li> </ul> |

<sup>19</sup> Includes entities that are not public business entities (as defined in U.S. GAAP), not-for-profit entities that have issued or are conduit bond obligors for securities that are traded, listed, or quoted on an exchange or an over-the-counter market or employee benefit plans that file or furnish financial statements with or to the U.S. Securities and Exchange Commission.

## 9.6 TRANSITION - LESSEES

We previously explained **when** entities should recognize leases on balance sheet and noted that the date at which a lease is recognized on balance sheet is the application date, which depends on the transition method selected. We will now explore **how** the entity measures those leases on balance sheet.

The initial measurement generally depends on whether lease classification changes between ASC 840 and ASC 842.

- ▶ If an entity elects the package of practical expedients, the entity applies the guidance for leases that do not change lease classification.
- ▶ If an entity does not elect the package of practical expedients, the entity must first reassess lease classification under ASC 842 before determining which transition guidance to apply.

### 9.6.1 Measurement of Existing Operating Leases Under ASC 840 and ASC 842

#### 9.6.1.1 General Requirements

If an entity elects the package of practical expedients, or the entity does not elect it but lease classification does not change, and the lease is an operating lease, the initial measurement of the lease at the application date is summarized as follows:

LL

A lessee initially measures the lease liability (LL) for a lease classified as an operating lease under ASC 840 and 842 at the present value of:

- ▶ The **remaining minimum rental payments** as determined under **ASC 840**, and
- ▶ Any amounts probable of being owed under a residual value guarantee.

This present value calculation is performed using the discount rate for the lease determined at the application date. An entity that is not a public business entity may use the risk-free rate. See Chapter 4 for additional details on the discount rate for the lease and the risk-free rate accounting policy.

ROU

The right-of-use asset (ROU) is initially measured at the amount of the initial measurement of the lease liability, adjusted for the following:

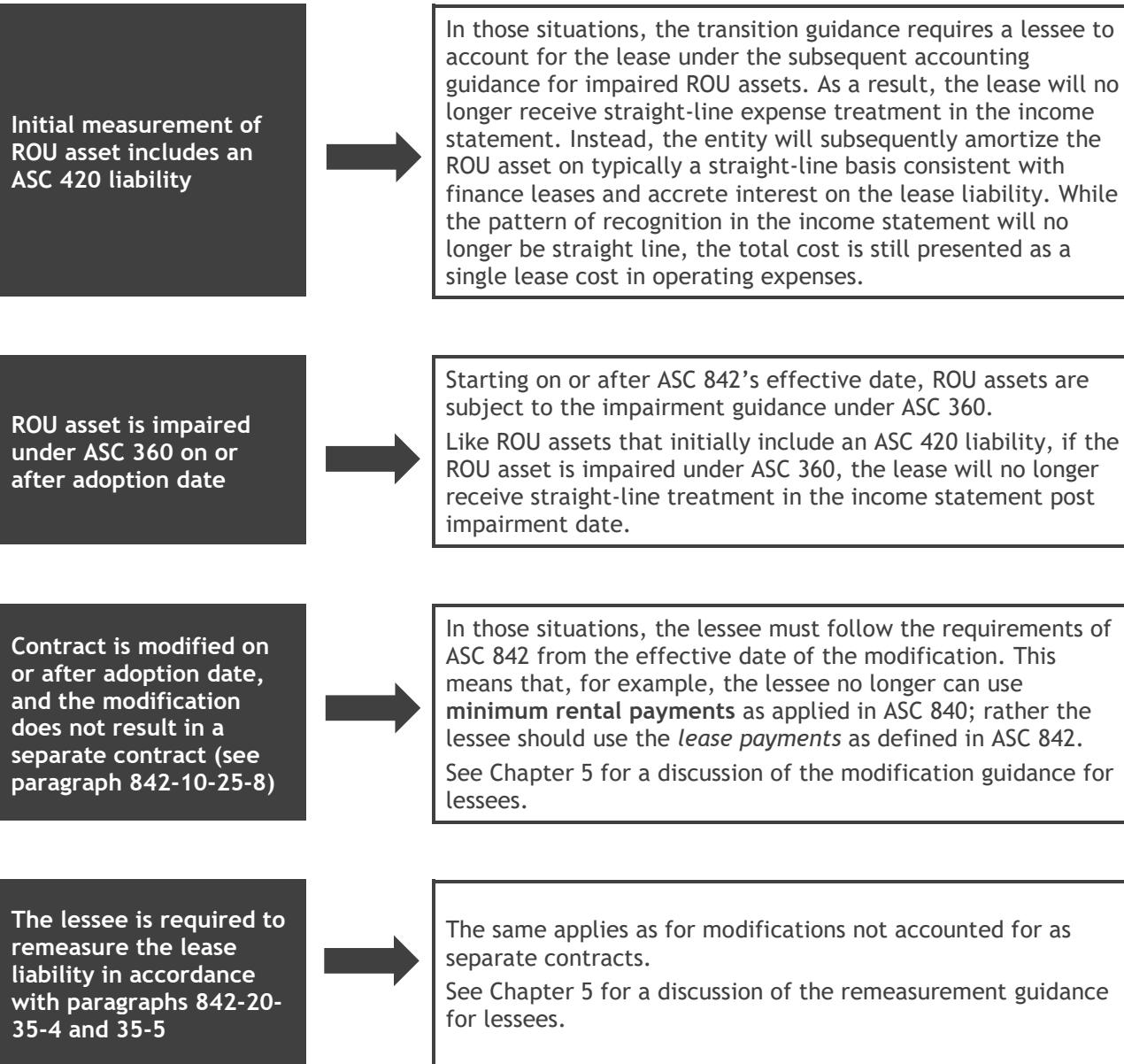
- ▶ Any prepaid or accrued rent payments,
- ▶ Any unamortized lease incentives,
- ▶ Any unamortized initial direct costs, and
- ▶ The carrying amount of any liability recognized in accordance with ASC 420 on exit or disposal cost obligations for the lease.

IDCs

Unless the entity elects the package of practical expedients, any unamortized initial direct costs (IDCs) that do not meet the definition of initial direct costs under ASC 842 should be written off as an adjustment to equity, unless the entity elects the modified retrospective approach and the costs were incurred after the beginning of the earliest period presented, in which case those costs should be written off as an adjustment to earnings when incurred.

The lease liability then continues to be measured each period like the initial measurement described above. The ROU asset also continues to be measured like the initial measurement described above, except if the carrying amount was adjusted for the carrying amount of an ASC 420 liability, in which case the lessee applies the recognition and subsequent measurement guidance when the ROU asset has been impaired.

The following provides additional subsequent measurement guidance for operating leases:



See also Chapter 5 for comprehensive guidance on lessee accounting.

**EXAMPLE 4 - INITIAL MEASUREMENT OF EXISTING OPERATING LEASE UNDER BOTH ASC 840 AND ASC 842**

- ▶ Let's continue Susie's lease of retail space in Example 2.
- ▶ Assume that Susie's adopts ASC 842 on 1/1/2019 using the transition alternative. Susie's application date is therefore 1/1/2019, which is its adoption date.
- ▶ Susie's elects the package of practical expedients but not the hindsight practical expedient.
- ▶ Susie's discount rate for the retail space lease is 6% at 1/1/2019.
- ▶ Susie's lease details relevant to the initial recognition of this lease were as follows:
  - *Lease term.* Originally, ten years (five-year noncancelable period plus first five-year renewal period). The remaining lease term at the application date is nine years.
  - *Payment terms.* Rent payments were \$50,000 per month plus one percent of sales during the initial five-year term. Payments then increase to \$55,000 per month. Future minimum rental payments were \$5,700,000 at 12/31/2018. Accrued rent resulting from straight-line recognition at 12/31/2018 was \$30,000. The rent payments based on percentage of sales are contingent rents and therefore are not included in the initial measurement of the lease.
  - *Initial direct costs.* Susie's incurred initial direct costs of \$22,000, which includes \$15,000 of legal fees for the review and negotiations of the lease and \$7,000 broker commission. The unamortized costs at 12/31/2018 are \$19,800. Because Susie's elected the package of practical expedients, it includes the entire unamortized balance of \$19,800 in the initial measurement of the ROU asset.

- ▶ Based on the above information, Susie's initially measures the operating lease as follows:

LL

**It measures the lease liability at the present value of the unpaid minimum rental payments at 1/1/2019, discounted at 6%. There is no residual value guarantee provided by Susie's.**

Based on the present value calculation, Susie's determines the initial measurement of the lease liability is \$4,390,078. On the same date, Susie's makes the rent payment of \$50,000 and therefore the lease liability is reduced to \$4,340,078.

ROU

and

IDCs

**It measures the ROU asset at the following:**

|   |              |
|---|--------------|
| Initial amount of the lease liability     | \$ 4,390,078 |
| Prepaid (accrued) rent                    | (30,000)     |
| Less unamortized lease incentives         | N/A          |
| Plus unamortized initial direct costs     | 19,800       |
| Less carrying amount of ASC 420 liability | <u>N/A</u>   |
| Initial measurement of the ROU asset      | \$ 4,379,878 |

- ▶ There is no adjustment to retained earnings for this lease considering the initial measurement requirements and the fact that Susie's elected the package of practical expedients.
- ▶ Susie's will continue to measure the lease liability and ROU asset in the same way as described above, and Susie's will recognize monthly straight-line lease expense of \$52,683 (consistent with the amount recognized under ASC 840) unless the ROU asset is impaired on or after ASC 842's effective date.
- ▶ Also, if on or after 1/1/2019 Susie's modifies the lease and it is not accounted for as a separate contract, or Susie's is required to remeasure the lease liability under paragraphs 842-20-35-4 and 35-5, Susie's will follow the requirements in ASC 842 from the effective date of modification or remeasurement date.

### 9.6.1.2 Executory Costs for Existing Operating Leases

As previously explained, a lessee is required to use the **minimum rental payments** as determined under ASC 840 when initially measuring existing operating leases in transition. However, because ASC 840 is not clear on whether executory costs (that is, taxes, insurance and maintenance) should be included or excluded as part of minimum rental payments, diversity in practice developed under ASC 840. Some lessees accounted for the entire rental payment as a minimum lease payment while others excluded from the minimum lease payment the portion representing executory costs of the leased asset. Therefore, questions arose about how a lessee should recognize existing operating leases in transition.

The SEC staff addressed those questions at the 2017 AICPA Conference on Current SEC and PCAOB Developments and, more recently, at the 2018 AICPA Conference on Current SEC and PCAOB Developments.



#### SEC STAFF GUIDANCE

##### Remarks before the 2018 AICPA Conference on Current SEC and PCAOB Developments

Andrew W. Pidgeon, Professional Accounting Fellow, Office of the Chief Accountant

Dec. 10, 2018

##### **Lessee transition - minimum rental payment composition policies**

The first consultation I am going to share builds upon a topic discussed last year at this conference by one of my colleagues related to lessee measurement of leases at transition to Topic 842.<sup>[2]</sup> Topic 842 requires lessees to measure leases at transition based on Topic 840<sup>[3]</sup> “remaining minimum rental payments.”<sup>[4]</sup> My colleague noted that diversity in practice exists related to executory costs, and their inclusion in, or exclusion from, Topic 840 minimum rental payments. He further noted that the staff did not object to registrants consistently applying their historical accounting policy regarding the composition of minimum rental payments when concluding whether executory costs should be included in remaining minimum rental payments for purposes of establishing the lease liability in transition to Topic 842.

Earlier this year, we received a consultation regarding a registrant’s ability to change its policies related to the composition of minimum rental payments, including a change at transition to Topic 842. For example, to change from excluding executory costs from, to including executory costs in, minimum rental payments. We observed that Topic 250<sup>[5]</sup> permits a registrant to change from one generally accepted accounting principle to another generally accepted accounting principle when there are at least two generally accepted principles if the change is preferable.<sup>[6]</sup> In response to the consultation, we communicated that the staff did not object to a registrant’s application of Topic 250 to change its policy relative to the composition of Topic 840 minimum rental payments, including a change at transition to Topic 842.<sup>[7]</sup>

[2] Michael P. Berrigan, Professional Accounting Fellow, Office of the Chief Accountant, U.S. Securities and Exchange Commission, *Remarks before the 2017 AICPA Conference on Current SEC and PCAOB Developments* (December 4, 2017), at: <https://www.sec.gov/news/speech/berrigan-aicpa-2017-conference-sec-pcaob-developments>.

[3] FASB ASC Topic No. 840, *Leases* (“Topic 840”).

[4] ASC 842-10-65-1(l).

[5] FASB ASC Topic No. 250, *Accounting Changes and Error Corrections* (“Topic 250”).

[6] ASC 250-10-45-2(b).

[7] Registrant requirements related to accounting policy changes are identified in Rule 10-01(b)(6) of Regulation S-X; see also, ASC 250-10-S99-4 and the related guidance in SAB Topic 6.G.2.b, *Reporting Requirements for Accounting Changes*

### 9.6.1.3 Payments Based on an Index or a Rate for Existing Operating Leases

Another question that arose on the application of minimum rental payments relates to those based on an index or a rate, and whether existing operating leases should be initially measured using the index or rate at lease inception or using the current value at the application date.

The SEC staff addressed that question at the 2018 AICPA Conference on Current SEC and PCAOB Developments.

#### SEC STAFF GUIDANCE

##### Remarks before the 2018 AICPA Conference on Current SEC and PCAOB Developments

Andrew W. Pidgeon, Professional Accounting Fellow, Office of the Chief Accountant

Dec. 10, 2018

##### **Lessee transition - minimum rental payment measurement policies**

More recently, we received another consultation regarding minimum rental payments and lessee transition to Topic 842. That consultation, submitted by a group of registrants, related to the measurement of minimum rental payments that are based on an index or a rate (“indexed payments”). Specifically, the inquiry related to whether at transition to Topic 842 leases with indexed payments should be measured based on the index or rate value from lease inception, or the then current index or rate value.

Topic 840 requires lessees to disclose “future minimum rental payments.”<sup>[8]</sup> We understand that in order to meet that disclosure requirement, some lessees disclose future minimum rental payments related to indexed payments based on the index or rate value at lease inception, and other lessees disclose those payments based on the current rate or index value. Similar to the consultation shared during last year’s conference regarding the composition of minimum rental payments, we observed that Topic 840 does not provide specific guidance with regard to the measurement of future minimum rental payments for disclosure of indexed payments. Therefore, the staff did not object to a registrant consistently applying their Topic 840 accounting policy regarding the measurement of future minimum rental payments for disclosure when concluding whether remaining minimum rental payments should be calculated based on the lease inception or current index or rate values for purposes of measuring leases at transition to Topic 842.

Additionally, the consultation discussed a registrant changing its policy relative to the measurement of future minimum rental payments for indexed payments, including at transition to Topic 842. Specifically, the consultation discussed a change from using lease inception index or rate values, to using current index or rate values to measure future minimum rental payments. The consultation concluded that the change was a change in accounting policy subject to Topic 250. The staff did not object to that conclusion. The staff further communicated that when evaluating whether that policy change is preferable, it would be reasonable for a registrant to consider as part of its Topic 250 analysis, if the lease obligation that results from using current index or rate values represents a better measurement of the registrant’s current lease obligations.

[8] ASC 840-20-50-2(a).

As previously noted, lessees will generally use future minimum rental payments determined in accordance with ASC 840 to calculate the lease liability and right-of-use asset to be recognized upon adoption of ASC 842. Therefore, how one determined future minimum rental payments when the payments are based on an index or rate for purposes of disclosures under ASC 840 should be consistent with how those payments are determined for purposes of adopting ASC 842.

While discussed in the context of public companies, we believe the above guidance equally applies to private companies.

#### 9.6.1.4 Discount Rate Used to Initially Measure Existing Operating Leases

As previously explained, the transition guidance in ASC 842 provides that existing operating leases should be initially measured using the discount rate for the lease at the application date. The guidance however does not specify whether the discount rate should be determined based on (1) the remaining lease term and remaining minimum rental payments, or (2) the total lease term and total minimum rental payments. The SEC staff addressed that question at the 2017 AICPA Conference on Current SEC and PCAOB Developments, which we believe also applies to private companies.



#### SEC STAFF GUIDANCE

##### Remarks before the 2017 AICPA Conference on Current SEC and PCAOB Developments

Michael P. Berrigan , Professional Accounting Fellow, Office of the Chief Accountant

Dec. 4, 2017

##### **Lease Transition – Incremental Borrowing Rate**

Another transition topic addressed by the staff relates to the incremental borrowing rate a lessee should apply when measuring the lease liability in transition. [...] registrants observed that the transition guidance does not specify whether the discount rate selected should be based on the original lease term or the remaining lease term.[7]

Some registrants concluded that the lessee should select a discount rate based on the original lease term as they believe that rate better reflects the borrowing rate embedded within the contract when the lessee entered into the arrangement. Other registrants concluded the lessee should select a rate based on the remaining lease term as they believe the rate more accurately reflects the rate applicable to the remaining lease liability recognized in transition. The staff observed that the transition guidance does not specify the lease term that should be used to determine the discount rate and further observed that either rate used in transition may significantly differ from the rate that would have been determined at commencement of the lease (i.e. the original commencement date of the lease). The staff concluded that the selection of either of these rates, that is either the rate based on the original lease term or the remaining lease term, is reasonable and ultimately did not object to a registrant's consistent application of either approach to determine the lessee's lease liabilities in transition.

[7] To illustrate, assume an entity previously entered into a 20 year lease with total payments of \$20 million and that the remaining lease term as of the earliest date presented in the financial statements upon adoption of ASC 842 is five years with remaining payments of \$5 million. The question raised is whether it is appropriate for the entity to select the discount rate applicable as of the date of the first period presented in the financial statements based on an original lease term (for example, the rate applicable for a 20 year borrowing with payments of \$20 million) or the remaining lease term (for example, the rate applicable for a five year borrowing with payments of \$5 million).

#### EXAMPLE 5 - DETERMINING THE DISCOUNT RATE FOR EXISTING OPERATING LEASES

- ▶ In Example 4, Susie's adopted ASC 842 on 1/1/2019 and elected the transition alternative. Its retail space lease commenced on 1/1/2018 and Susie's initially determined that the lease term under ASC 840 was ten years (and therefore nine years remain at 1/1/2019). Susie's total fixed lease payments under the lease were \$6,300,000 and payments remaining at 12/31/2018 are \$5,700,000 as disclosed in its footnotes.
- ▶ In determining the discount rate for all of its existing operating leases, including the retail space lease just described, Susie's is permitted to use either of the following two approaches. The approach Susie's selects must be applied consistently to all of its existing operating leases when transitioning to ASC 842, and Susie's should disclose which approach it applied.
  - **Approach A: Use Remaining Lease Term and Remaining Minimum Rental Payments.** For its lease of retail space above, Susie's would determine the discount rate based on (1) a remaining lease term of nine years, and (2) remaining lease payments of \$5,700,000.
  - **Approach B: Use the Total Lease Term and Total Minimum Rental Payments.** For its lease of retail space above, Susie's would determine the discount rate based on (1) a total lease term of ten years, and (2) total lease payments of \$6,300,000.

### 9.6.1.5 Lessee Practical Expedient Not to Separate During Transition

ASC 842 provides a practical expedient for lessees not to separate the nonlease components of a contract (for example, maintenance or operation of the underlying asset) from the associated lease component. The practical expedient must be elected by asset class. While the transition guidance specifically addresses certain practical expedients (for example, the short-term lease exemption), it does not address the lessee practical expedient not to separate. However, while not addressed in transition, we believe an entity may elect, by asset class, the lessee practical expedient to not separate during transition.

- ▶ If elected in transition, we believe the entity should apply the lessee practical expedient also to new leases within that asset class that commence on or after the effective date.
- ▶ If not elected in transition (and since it is not discussed in transition), the entity may still elect the lessee practical expedient to new leases within that asset class that commence on or after the effective date.

### 9.6.1.6 Impairment Considerations

Prior to adopting ASC 842, an entity may have recognized an impairment loss on its asset group(s). In that situation, the impairment loss was allocated to the recognized long-lived assets in the asset group. Because operating leases were not recognized on balance sheet before ASC 842, operating leases did not receive any allocation of the impairment loss at that time. Accordingly, stakeholders questioned whether upon adoption of ASC 842 an entity is required to reallocate prior impairment losses because of the new asset recognized for an existing operating lease.

The FASB specifically addressed this question at a public Board meeting in November 2016 in which it clarified that it was not its intent to require entities to reallocate prior impairment losses. The FASB also observed that reallocating prior impairment losses would result in writing up some of the other long-lived assets in the asset group, which is not permitted under U.S. GAAP. Accordingly, the impairment guidance in ASC 360 applies to right-of-use assets starting only at the effective date. See Chapter 5 on lessee accounting for guidance on impairment of right-of-use assets.

Also, prior to adopting ASC 842, an entity may have recognized an impairment loss for its asset groups that resulted in the complete write-off of the recognized long-lived assets in the asset group (or a write-off limited to the fair value of the individual long-lived assets), with a remaining and “unused” impairment loss. Had an operating lease in the asset group been recognized on balance sheet at the date of impairment, some or all of the unused impairment losses may have been recognized. Accordingly, stakeholders questioned whether on adoption of ASC 842 an entity is required or permitted to recognize some or all of the prior unused impairment losses.

In those situations, we believe an entity may reduce the amount of the right-of-use asset initially recognized for unused impairment losses with a corresponding adjustment to retained earnings, assuming the asset group to which the operating lease pertains continues to be impaired. We also believe it would be acceptable for the entity to recognize the impairment in earnings on adoption rather than revisiting prior impairments to determine whether unused impairment losses existed. If the entity elects the modified retrospective transition and the impairment occurred during the comparative periods, the adjustment should be recognized in earnings of the relevant period.

### 9.6.1.7 Sublease Liabilities Existing at Adoption Date

As previously discussed, ASC 842 provides explicit transition guidance for leases with existing ASC 420 liabilities. However, ASC 842 is silent about existing sublease liabilities recognized under ASC 840-20-25-15 when costs expected to be incurred under an operating sublease exceed anticipated revenue on the operating sublease. Because of the lack of guidance, there may be multiple approaches in transition depending on the facts and circumstances, including netting the existing sublease liability against the right-of-use asset (like the treatment of ASC 420 liabilities in transition, in which case the entity applies the guidance on right-of-use assets that are impaired), or writing off the existing sublease liability through retained earnings as part of the cumulative effect adjustment at transition (and evaluating the right-of-use asset for potential impairment).

### 9.6.2 Measurement of Existing Capital Leases Under ASC 840 That Are Finance Leases Under ASC 842

If an entity elects the package of practical expedients, or the entity does not elect it but lease classification does not change (that is, the lease is a capital lease under ASC 840 and a finance lease under ASC 842), the initial measurement of the lease at the application date is summarized as follows:

LL

A lessee initially measures the lease liability for a lease classified as a capital lease under ASC 840 and classified as a finance lease under ASC 842 at the carrying amount of the capital lease obligation under ASC 840.

ROU

The ROU asset is initially measured at the carrying amount of the capital lease asset under ASC 840, plus any unamortized initial direct costs that meet the definition of initial direct costs under ASC 842, or all unamortized initial direct costs if the entity elects the package of practical expedients.

IDCs

Unless the entity elects the package of practical expedients, any unamortized initial direct costs that do not meet the definition of initial direct costs under ASC 842 and that are not included in the measurement of the capital lease asset under ASC 840 should be written off as an adjustment to retained earnings, unless the entity elects the modified retrospective approach and the costs were incurred after the beginning of the earliest period presented, in which case those costs should be written off as an adjustment to earnings when incurred.

In short, other than the change in description of the capital lease asset to right-of-use asset and the capital lease obligation to lease liability, the transition guidance for existing capital leases under ASC 840 that are classified as finance leases under ASC 842 results in the carryforward of the existing asset and liability under ASC 840.

After initial recognition:

- ▶ If the entity elected the modified retrospective transition, the lessee follows the general subsequent measurement guidance in ASC 840 before the effective date, and
- ▶ Irrespective of the transition method elected, the lessee applies ASC 842 on and after the effective date. As an exception, when applying the subsequent measurement guidance in ASC 842 after adoption, a lessee does not remeasure the lease payments for changes in amounts probable of being owed under residual value guarantees. This is because the capital lease obligation under ASC 840 already included the full amount of the residual value guarantee.

The entity also classifies the assets and liabilities held under capital leases as right-of-use assets and lease liabilities arising from finance leases for presentation and disclosure purposes.

If the entity modifies the contractual terms and conditions of the lease on or after the effective date and the modification does not result in a separate contract, or the lessee is required to remeasure the lease liability (see Chapter 5 for additional guidance), the lessee follows the guidance in ASC 842 from the effective date of the modification or the remeasurement date.

### 9.6.3 Measurement for Leases That Change Classification

If an entity does not elect to apply the package of practical expedients during transition, then it must reassess lease classification under ASC 842, which may or may not result in changes:

- ▶ If lease classification does not change, the lessee applies the guidance described in the preceding two sections to the lease.
- ▶ If classification changes, a lessee should initially recognize those leases at the application date as further described below. However, we believe that changes in classification should be infrequent for most entities considering the similarities in classification guidance between ASC 840 and ASC 842.

#### 9.6.3.1 Leases Classified as Operating Leases Under ASC 840 and Classified as Finance Leases Under ASC 842

A lessee initially measures a lease classified as an operating lease under ASC 840 and classified as a finance lease under ASC 842 as follows:

LL

The lease liability is measured at the present value of:

- ▶ The **remaining minimum rental payments** as determined under ASC 840, and
- ▶ Any amounts probable of being owed under a residual value guarantee.

This present value calculation is performed using the discount rate for the lease determined at the application date. An entity that is not a public business entity may use the risk-free rate. See Chapter 4 for additional details on the discount rate for the lease and the risk-free rate accounting policy.

ROU

The ROU asset is first calculated as the applicable proportion of the lease liability at the commencement date. The applicable proportion of the lease liability is the remaining lease term at the application date relative to the total lease term.

The ROU recognized is then adjusted by the carrying amount of any prepaid or accrued lease payments and the carrying amount of any liability recognized in accordance with ASC 420.

IDCs

Because the entity did not elect the package of practical expedients, any unamortized initial direct costs that do not meet the definition of initial direct costs under ASC 842 should be written off as an adjustment to retained earnings, unless the entity elects the modified retrospective approach and the costs were incurred after the beginning of the earliest period presented, in which case those costs should be written off as an adjustment to earnings when incurred.

Also, if the entity modifies the contractual terms and conditions of the lease on or after the effective date and the modification does not result in a separate contract, or the lessee is required to remeasure the lease liability for any reason (see Chapter 5 for additional guidance), the lessee should follow the guidance in ASC 842 from the effective date of the modification or the remeasurement date. This means that the lessee will no longer use the *minimum rental payments* as applied under ASC 840 to account for the lease but rather will use the *lease payments* as defined in ASC 842.

### 9.6.3.2 Leases Classified as Capital Leases Under ASC 840 and Classified as Operating Leases Under ASC 842

A lessee initially measures a lease classified as a capital lease under ASC 840 and classified as an operating lease under ASC 842 as follows:

LL

The initial measurement of the lease liability is the present value of the *lease payments* not yet paid as defined under ASC 842 (**not** the minimum rental payments determined under ASC 840) discounted using the discount rate for the lease determined at the application date.

ROU

The ROU asset is initially measured using the amount of the initial measurement of the lease liability and is then adjusted for the following, as applicable, depending on the transition method elected:

- ▶ Any prepaid (accrued) lease payments,
- ▶ Any (unamortized) lease incentives,
- ▶ Any (unamortized) initial direct costs, and
- ▶ Any difference between the carrying amount of the capital lease asset and capital lease obligation under ASC 840 that are derecognized at the application date (which are accounted for in the same manner as prepaid or accrued rent).

IDCs

Because the entity did not elect the package of practical expedients, any unamortized initial direct costs that do not meet the definition of initial direct costs under ASC 842 should be written off as an adjustment to retained earnings, unless the entity elects the modified retrospective approach and the costs were incurred after the beginning of the earliest period presented, in which case those costs should be written off as an adjustment to earnings when incurred.

The lease is then accounted for under ASC 842 like any new lease would be.

If the entity modifies the contractual terms and conditions of the lease on or after the effective date, and the modification does not result in a separate contract, or the lessee is required to remeasure the lease liability for any reason (see Chapter 5 for additional guidance), the lessee applies ASC 842.

### 9.6.4 Leasehold Improvements Amortization – Common Control Leases

Private company stakeholders raised concerns about ASC 842 application to common control arrangements (such as arrangements between sister entities controlled by a common owner). Concerns included the amortization of leasehold improvements in common control leases. In response to those concerns, the FASB issued ASU 2023-01, Leases (Topic 842): *Common Control Arrangements*.

ASU 2023-01 states that:

- ▶ A lessee amortizes leasehold improvements associated with a common control lease over the useful life of those improvements to the common control group, regardless of the lease term, if the lessee controls the use of the underlying asset through a lease. If the lessor obtained the right to control the underlying asset's use through a lease with another entity outside the common control group, then the amortization period cannot exceed the amortization period of the common control group determined in accordance with ASC 842-20-35-12.
- ▶ If the lessee loses control of the use of the leased asset to another entity in the common control group, the remaining balance of leasehold improvements is accounted for as a transfer between entities under common control through an adjustment to equity (or net assets for a not-for-profit entity).

#### BDO INSIGHTS - AMENDMENTS APPLY TO ALL ENTITIES

While the FASB received concerns about the requirements in ASC 842 mostly from private company stakeholders, it concluded that the changes better reflect the economics of leasehold improvements in common control leases and therefore the changes apply to all entities. This means that public entities that have adopted ASC 842 may need to make changes to existing processes, systems or controls to comply with this new guidance.

See Section 5.6.3.2 for further discussion about the requirements and Section 9.2.1 for effective dates.

ASU 2023-01 is applied using the following transition methods:

| STATUS OF ASC 842 ADOPTION                 | TRANSITION METHODS   |
|--|--|
| Entities that have not yet adopted ASC 842 | <p>Either:</p> <ul style="list-style-type: none"> <li>▶ The same transition method elected to apply ASC 842 (see Section 9.3)</li> <li>▶ One of the prospective approaches described below</li> </ul>  |
| Entities that have already adopted ASC 842 | <p>Any of the following:</p> <ul style="list-style-type: none"> <li>▶ Prospectively to all new leasehold improvements recognized on or after the date that the entity first applies ASU 2023-01</li> <li>▶ Prospectively to all new and existing leasehold improvements recognized on or after the date that the entity first applies ASU 2023-01, with any remaining unamortized balance of existing leasehold improvements amortized over their remaining useful life to the common control group determined at that date</li> <li>▶ Retrospectively to the beginning of the period in which the entity first applied ASC 842 for leasehold improvements that exist at the adoption date of ASU 2023-01, with any leasehold improvements that otherwise would not have been amortized or impaired recognized through a cumulative-effect adjustment to the opening balance of retained earnings at the adoption date of ASC 842</li> </ul> |

## 9.7 TRANSITION - LESSORS

### 9.7.1 Measurement

Like lessees, the measurement of existing leases generally depends on whether classification changes between ASC 840 and ASC 842.

- ▶ If an entity elects the package of practical expedients, the entity applies the guidance for leases that do not change classification.
- ▶ If an entity does not elect the package of practical expedients, the entity must first reassess lease classification under ASC 842 before determining which transition guidance applies.

The following tables summarize the transition provisions for each lease classification scenario:

Existing lease is an operating lease under ASC 840 and ASC 842

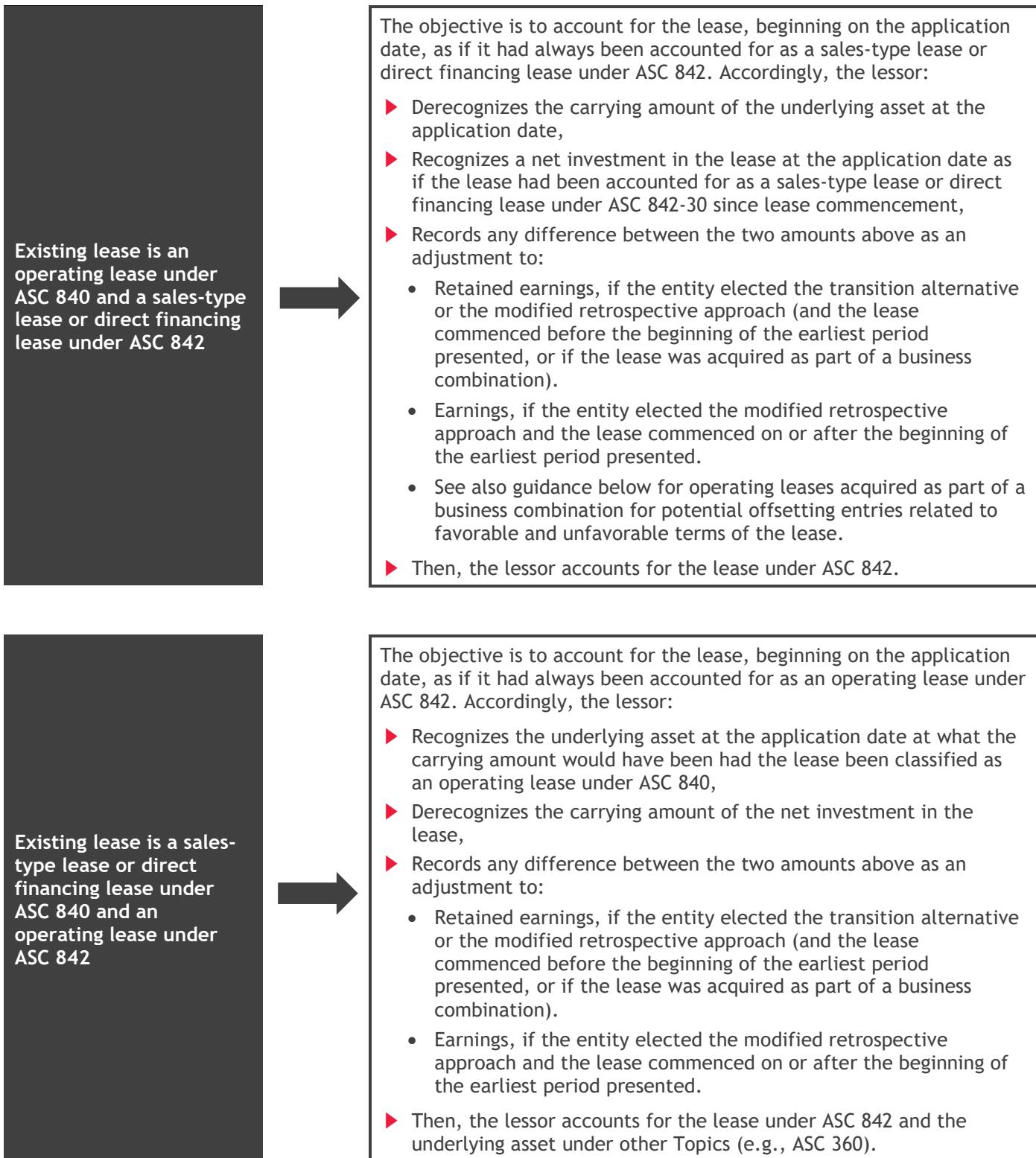


- ▶ Continue to recognize at the application date the underlying asset along with any related assets or liabilities, such as rent receivables.
- ▶ Account for previous securitized receivables as secured borrowings in accordance with other Topics.
- ▶ If the entity does not elect the package of practical expedients, any unamortized initial direct costs that do not meet the definition of initial direct costs under ASC 842 should be written off as an adjustment to retained earnings, unless the entity elects the modified retrospective approach and the costs were incurred after the beginning of the earliest period presented, in which case those costs should be written off as an adjustment to earnings when incurred.

Existing lease is a sales-type lease or direct financing lease under ASC 840 and ASC 842



- ▶ Continue to recognize at the application date the carrying amount of the net investment in the lease. This includes any unamortized initial direct costs capitalized as part of the net investment in the lease for a direct financing lease under ASC 840, regardless of whether the package of practical expedients is elected.
- ▶ If the entity elected the modified retrospective transition, the lessor accounts for the lease under ASC 840 before the effective date of ASC 842.
- ▶ Regardless of the transition method elected, beginning on the effective date of ASC 842 the lessor applies the recognition, subsequent measurement, presentation, and disclosure guidance in ASC 842.
- ▶ Beginning on the effective date, if the lessor modifies the lease and the modification is not accounted for as a separate contract, the accounting depends on the classification of the modified lease. See Chapter 6 for additional guidance.
- ▶ A lessor does not remeasure the net investment in the lease on or after the effective date unless the lease is modified and the modification is not accounted for as a separate contract.



### 9.7.2 Leveraged Leases

Unlike the legacy leases guidance, a lessor can no longer classify a lease as a leveraged lease under ASC 842. However, existing leveraged leases that commenced before the effective date of ASC 842 are grandfathered and continue to be accounted for by the lessor like under ASC 840 until they expire or are modified (see ASC 842-50). If a leveraged lease is modified on or after the effective date, it must be accounted for as a new lease as of the effective date of the modification in accordance with ASC 842. A lessor also applies the legacy leases guidance to a leveraged lease that commenced before the effective date and that is acquired in a business combination or an acquisition by a not-for-profit entity, unless that lease is modified.

### 9.7.3 Practical Expedient Not to Separate for Operating Leases

ASU 2018-11, *Leases (Topic 842) - Targeted Improvements*, provided lessors with an accounting policy by asset class to combine nonlease components with the associated lease component when certain criteria are met. When those criteria are met, the accounting for the combined component is dictated by the predominant component(s) (that is, ASC 606 or ASC 842). Once the practical expedient is elected for an asset class, the lessor is required to apply it to all future lease contracts within that asset class that meet the criteria for combination. See Chapter 4 for additional guidance.

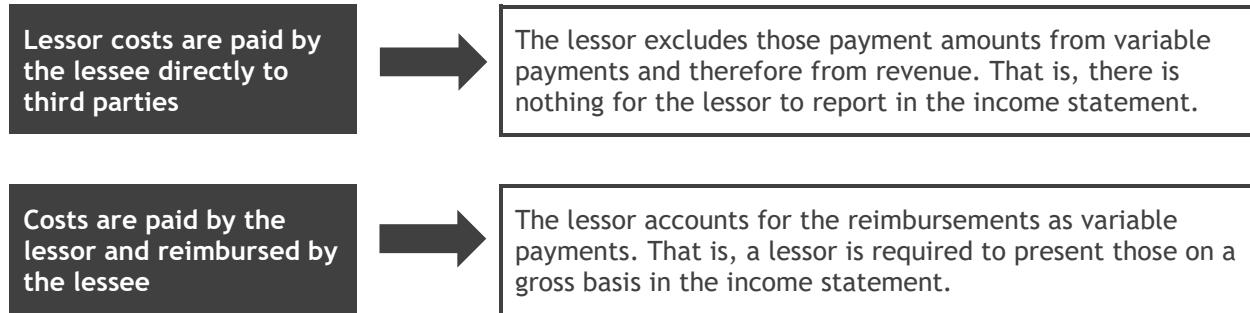
This lessor practical expedient must be elected at the effective date and must be applied to all new *and* existing leases. As a result, the election of the practical expedient may change presentation for some lessor entities. For example, lessor entities that previously presented taxes, insurance and maintenance recoveries separately from rental income can longer present those recoveries separately in the income statement if they elect the lessor practical expedient not to separate (see chapter 8 for additional details).

For entities that adopted ASC 842 before the issuance of ASU 2018-11, refer to paragraph 842-10-65-2 for additional effective dates and transition guidance.

### 9.7.4 Narrow Scope Improvements for Lessors

ASU 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, simplifies lessor's accounting for sales taxes and certain lessor costs, and clarifies the recognition of certain variable payments for contracts with lease and nonlease components.

- ▶ **Sales Taxes and Similar Taxes.** A lessor can make an accounting policy election to exclude from the consideration in the contract and from variable payments not included in the consideration all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific lease revenue-producing transaction and collected by the lessor from a lessee. This includes for example sales, use, value added, and some excise taxes. However, taxes assessed on a lessor's total gross receipts or on the lessor as owner of the underlying asset (for example, property taxes) are excluded from the scope of this election. When the lessor makes this election, it should comply with the disclosure requirements in paragraph 842-30-50-14.
- ▶ **Recognition and Presentation for Lessor Costs in Net Leases.** A lessor may incur various costs in its role as a lessor or as owner of the underlying asset (lessor costs), such as property taxes and certain insurance costs. A requirement for the lessee to pay those costs, whether directly to a third party on behalf of the lessor or as a reimbursement to the lessor, does not transfer a good or service to the lessee. ASC 842 initially required a lessor to report those amounts as revenue and expenses (that is, on a gross basis) whether the lessee reimburses the lessor or pays such costs on lessor's behalf to a third-party. However, stakeholders raised concerns with this requirement, including challenges with estimating those costs when the lessee pays the amounts directly to third parties, and noted limited benefits because the amounts in the income statement would net to zero. In response to those concerns, the FASB issued ASU 2018-20 which made the following amendments for this issue.



- ▶ **Accounting for Variable Payments in Contracts with Lease and Nonlease Components.** The ASU clarified the requirements in paragraph 842-10-15-40 for lease contracts in which the terms of the variable payment amount (other than those that depend on an index or a rate) relate to a lease component (even partially) when the changes in facts and circumstances on which the variable payment is based occur.

See Chapter 3 for additional details. While the effective date and transition approach differs for entities that did not early adopt ASC 842 as compared to those that did, the new guidance nevertheless must be applied to all new *and existing* leases. For entities that adopted ASC 842 before the issuance of ASU 2018-20, refer to paragraph 842-10-65-3 for additional effective dates and transition guidance.

### 9.7.5 Codification Improvements

ASU 2019-01, *Leases (Topic 842) - Codification Improvements*, clarifies the application of certain aspects of ASC 842 primarily for financial institutions.

- ▶ **Determining Fair Value of the Underlying Asset.** ASC 842 initially did not include an exception that existed under ASC 840 for determining fair value for lessors who are not manufacturers or dealers (generally financial institutions and captive finance companies). In response to feedback from lessors previously qualifying for the exception in ASC 840, the FASB added a similar exception under ASC 842. As a result, for lessors that are not manufacturers or dealers, the fair value of the underlying asset at lease commencement is defined as its cost, reflecting any volume or trade discounts that apply. This exception applies only if there has not been a significant lapse of time between the acquisition of the underlying asset and lease commencement. If there has been a significant lapse of time, the lessor applies the ASC 820 definition of fair value like any other lessor.
- ▶ **Cash Flow Classification for Sales-Type and Direct Financing Leases.** ASC 842 initially required lessors to classify all cash receipts from leases as operating activities, regardless of whether the lease was an operating lease, sales-type lease, or direct financing lease. However, the FASB received feedback from lessor stakeholders within the scope of ASC 942, *Financial Services—Depository and Lending*, that they historically have presented principal payments received under leases within investing. Following that feedback, the FASB clarified that lessors that are depository and lending institutions within the scope of ASC 942 should present all “principal payments received under leases” within investing activities.

Refer to paragraph 842-10-65-2 for effective dates and transition guidance.

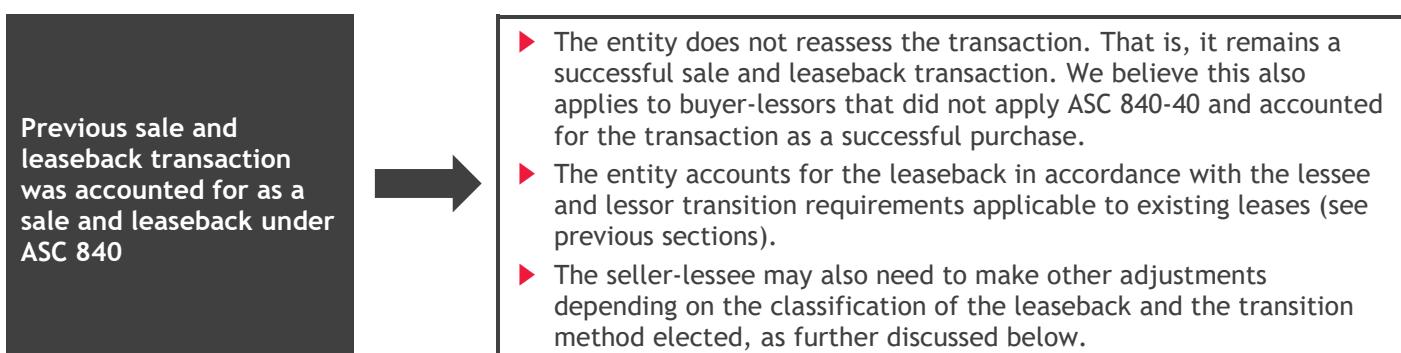
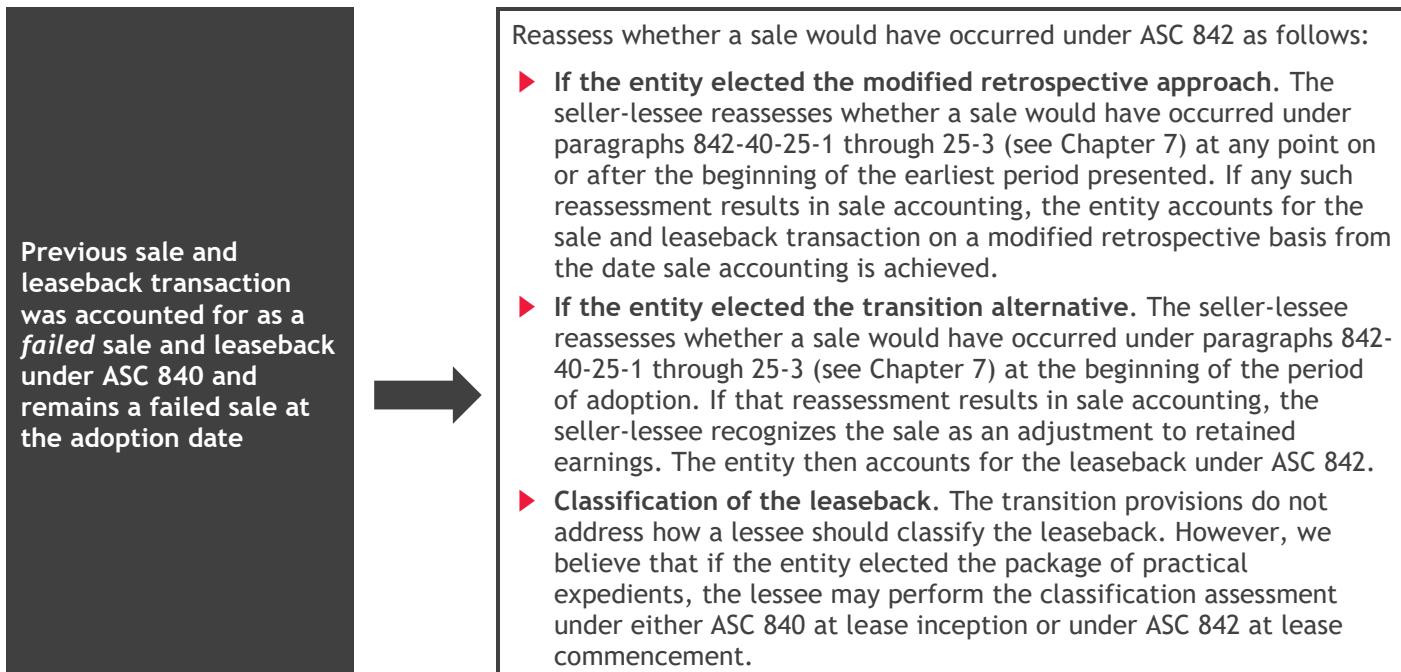
### 9.7.6 Certain Leases With Variable Lease Payments

ASU 2021-05, *Leases (Topic 842) - Lessors—Certain Leases with Variable Lease Payments*, addressed the recognition of a selling loss at the commencement date (a “day-one loss”) for sales-type or direct financing leases because of variable lease payments that do not depend on an index or a rate. The ASU addressed this issue by requiring lessors to classify such leases as an operating lease when the lease includes variable lease payments that do not depend on an index or a rate and that would result in the recognition of a selling loss at lease commencement if the lease were classified as a sales-type lease or direct financing lease. See Chapter 4 for additional details. Also refer to paragraph 842-10-65-5 for effective dates and transition guidance.

## 9.8 OTHER TRANSITION REQUIREMENTS

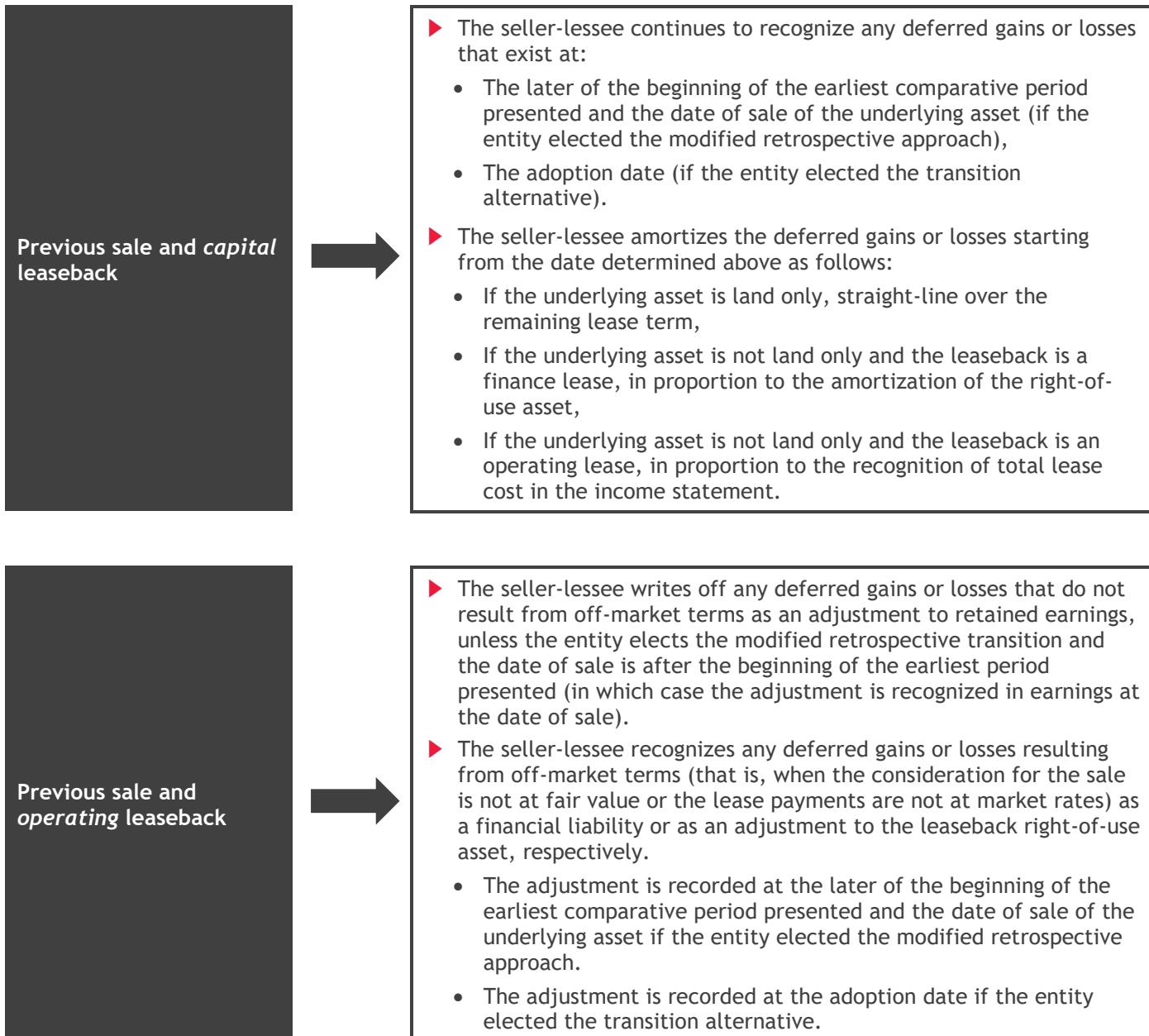
In addition to the above transition provisions applicable to lessees and lessors, ASC 842 includes other transition provisions, including prior sale and leaseback transactions, existing build-to-suit lease arrangements and amounts previously recognized as part of business combinations.

### 9.8.1 Sale and Leaseback Transactions Before the Effective Date



### 9.8.1.1 Deferred Gains or Losses on Existing Sale and Leaseback Transactions

As discussed above, a previous sale and leaseback transaction that was accounted for as a sale and leaseback under ASC 840 is not reassessed under ASC 842. However, there may be deferred gains or losses recognized on those transactions. The transition provisions require that certain adjustments be made depending on the classification of the leaseback and the transition method elected.



#### EXAMPLE 6 - DEFERRED GAIN ON EXISTING SALE AND LEASEBACK TRANSACTION

Susie's has a number of retail stores that it leases, like the one we illustrated earlier. Susie's also has one such retail store that it leases as a result of a past sale and leaseback transaction in which Susie's sold the retail store it owned and then leased it back for some period of time. The terms of the transaction were at market. The transaction was properly accounted for as a sale under ASC 840 (i.e., not as a failed sale) and the leaseback was determined to be an operating lease. Further, the profit on sale did not exceed the present value of the minimum lease payments under ASC 840. Therefore, the entire gain was deferred over the leaseback term.

In accordance with ASC 842's transition requirements, Susie's does not reassess whether the sale and leaseback transaction would have qualified for sale accounting under ASC 842. Also, because there were no off-market terms, Susie's should recognize the deferred gain balance on the sale-leaseback transaction as a cumulative-effect adjustment to retained earnings at the adoption date if it elects the transition alternative. If Susie's elects the modified retrospective approach, the adjustment also would be recorded in retained earnings unless the date of sale is after the beginning of the earliest period presented, in which case the adjustment would be to earnings in the relevant period.

#### 9.8.2 Build-to-Suit Arrangements

An entity (as lessee) may be deemed the accounting owner of a construction project solely because of the transaction's build-to-suit designation under ASC 840. In that situation, the entity recognized the asset (for example, for the construction costs the lessee or lessor incurred) and a corresponding liability.

The transition provisions generally require the lessee to derecognize those assets and liabilities on a modified retrospective basis unless the construction is still in progress at the adoption date and the lessee is determined to be the accounting owner under ASC 842. See paragraph 842-40-55-5 and Chapter 7 on other topics for additional guidance on determining whether a lessee controls the asset under construction under ASC 842 and therefore is considered the accounting owner.

The date at which the lessee derecognizes the build-to-suit assets and liabilities depends on the transition method the entity elects.

- ▶ **The entity elects the modified retrospective approach.** The lessee derecognizes those build-to-suit assets and liabilities with an adjustment to retained earnings, if any, at the later of (1) the beginning of the earliest comparative period presented and (2) the date the lessee is determined to be the accounting owner under ASC 840.
- ▶ **The entity elects the transition alternative.** The lessee derecognizes those build-to-suit assets and liabilities with an adjustment to retained earnings, if any, at the adoption date.

The lessee then applies the lessee transition requirements to the lease as discussed in the earlier sections. The transition provisions do not address how a lessee classifies the lease in that situation. However, we believe that if the entity elected the package of practical expedients, the lessee may perform the classification assessment under either ASC 840 at lease inception or under ASC 842 at lease commencement.

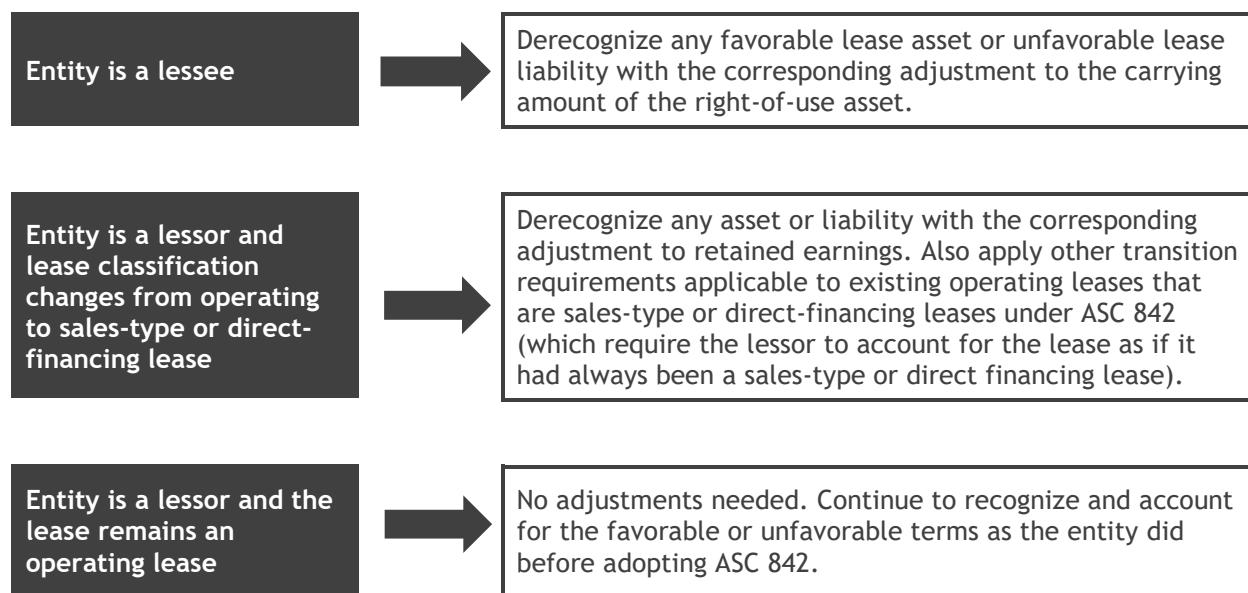
Also note that if the construction period of the build-to-suit lease concluded before the beginning of the earliest period presented (if the entity elects the modified retrospective approach) or the effective date (if the entity elects the transition alternative) and the transaction qualified as a sale and leaseback transaction under ASC 840, the lessee does not apply the transition provisions for build-to-suit arrangements discussed above but instead applies the general lessee transition requirements for the lease. However, if the transaction did not qualify as a sale and leaseback transaction under ASC 840, the entity applies the build-to-suit transition provisions and derecognizes the asset and related liability. The company does not apply the sale and leaseback transition provisions, and does not assess whether the transaction would qualify as a sale under ASC 842.

### BDO INSIGHTS – WRITE OFF OF ASSETS AND LIABILITIES IN A BUILT-TO-SUIT ARRANGEMENT

The transition provisions of ASC 842 require the write-off of assets and liabilities recognized solely because of a transaction's build-to-suit designation under ASC 840. As such, an entity should carefully analyze the composition of those assets and liabilities in determining whether the full amount of the asset and liability should be written off. For example, the asset recognized may include lease prepayments (e.g., the lessee paid construction costs of the lessor) or leasehold improvements that the lessee paid for themselves, or the liability may include lessor lease incentives received related to leasehold improvements, items which are not *solely* related to the build-to-suit designation. In those situations, we believe those amounts retain their characteristics (e.g., as prepaid lease payments, leasehold improvement assets or lease incentives) and, accordingly, they should not be written off but instead included in the initial measurement of the right-of-use asset or as leasehold improvements.

### 9.8.3 Business Combinations

The transition provisions of ASC 842 require entities to derecognize assets or liabilities recognized under ASC 805 on business combinations related to favorable or unfavorable terms for acquired operating leases. The transition requirements depend on whether the entity is the lessee or the lessor, and for the lessor, whether lease classification changes from operating lease to sales-type or direct financing lease (when the lessor entity does not elect the package of practical expedients).



### 9.9 APPLICATION OF THE PORTFOLIO APPROACH IN TRANSITION

ASC 842 permits an entity to apply the leases guidance on a portfolio basis. Specifically, paragraph 120 in the Basis for Conclusions to ASU 2016-02 indicates that the standard permits both a lessee and a lessor to apply the leases guidance at a portfolio level for leases with similar characteristics as long as the use of the portfolio approach would not differ materially from the application of ASC 842 to the individual leases in the portfolio. Paragraphs 842-20-55-18 through 55-20 provide an example in which the portfolio approach is utilized in determining the discount rate for the lease.

We believe the application of the portfolio approach may be particularly beneficial during transition for the recognition of existing operating leases on balance sheet. For example, an entity (lessee) may decide to group existing operating leases into portfolios of leases with similar characteristics (for example, in terms of lease payments, lease term, and so forth) to determine the discount rate to initially measure those leases.

## APPENDIX A – OTHER BDO PUBLICATIONS

Other BDO publications are available at [www.bdo.com/Insight](http://www.bdo.com/Insight)

# APPENDIX B – SUMMARY OF SIGNIFICANT CHANGES

The following table lists the significant changes in this April 2023 edition of the Blueprint as compared to the December 2021 edition:

| SECTION | DESCRIPTION OF CHANGE   |
|---------|---|
| 1.3.1   | Updated to expand discussion on embedded derivative considerations in a lease host  |
| 1.3.4   | Added guidance on leases in research and development activities   |
| 2.2.2   | Added BDO Insights on supplier substitution rights with requirements setting a high hurdle  |
| 2.4     | Added guidance related to joint operations or arrangements  |
| 2.5     | Added section for ASU 2023-01, Leases (Topic 842): Common Control Arrangements  |
| 4.4     | Updated BDO Insights to expand discussion on identifying unavoidable fixed payments   |
| 5.5.2   | Updated guidance on initial measurement of leases by lessees for various practice issues, including leases in research and development activities |
| 5.6.1.1 | Added guidance on amortization of ROU asset associated with finance lease of land   |
| 5.6.2   | Added Example 5 on accounting for operating lease with non-consecutive periods of use   |
| 5.6.3   | Updated discussion on leasehold improvements for ASU 2023-01, Leases (Topic 842): Common Control Arrangements                                     |
| 5.8     | Updated section for various lessee practice issues on lease modifications   |
| 6.7     | Updated section for various lessor practice issues on lease modifications   |
| 7.2.2.5 | Updated consolidation considerations of buyer-lessor entities in sale and leaseback transactions  |
| 7.2.2.8 | Expanded sale and leaseback scope considerations for sales subject to a preexisting lease   |
| 7.2.2.9 | Added sale and leaseback scope considerations for modification of a finance lease to an operating lease   |
| 7.2.3   | Updated BDO Insights on level of analysis for sale assessment in sale and leaseback transactions  |
| 7.3.3   | Added BDO Insights on lessee short-term lease election in business combinations   |

|         |  |
|---------|--|
| 8.2.2.1 | Added BDO Insights for determining current lease liabilities in a classified balance sheet   |
| 8.3.2   | Updated for disclosure requirements related to ASU 2023-01, Leases (Topic 842): Common Control Arrangements  |
| 9.5.4   | Added transition considerations for common control arrangements under ASU 2023-01, Leases (Topic 842): Common Control Arrangements                     |
| 9.6.4   | Added transition considerations for leasehold improvements in common control leases under ASU 2023-01, Leases (Topic 842): Common Control Arrangements |

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